85-555

No.

Supreme Court, U.S.
FILED
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IN THE

Supreme Court of the United States

OCTOBER TERM, 1985

BANKERS TRUST COMPANY,
Petitioner,

vs.

THELMA T. METGE, Executrix of the Estate of August Metge, and ELIZABETH G. SHEPARD, on behalf of themselves and on behalf of all others similarly situated,
Respondents.

On Writ of Certiorari to the United States Court of Appeals
For the Eighth Circuit

PETITION FOR WRIT OF CERTIORARI

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QUESTION PRESENTED

May a Circuit Court permit aiding-abetting liability of a banker-lender under § 10-b of the Securities Act on what amounts to a negligence standard in contravention of *Ernst & Ernst v. Hochfelder,* 425 U.S. 185, 47 L.Ed.2d 688, 196 S.Ct. 1375 (1976) by changing the definition of fraud to not require *scienter* (knowledge of the fraud) or substantial assistance to the fraud as elements of proof?

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THELMA T. METGE, Executrix of the Estate of August Metge, and ELIZABETH G. SHEPARD, on behalf of themselves and on behalf of all others similarly situated,
Respondents.

On Writ of Certiorari to the United States Court of Appeals For the Eighth Circuit

PETITION FOR WRIT OF CERTIORARI

Defendant, Bankers Trust Company ("the Bank" or "BTC"), petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Eighth Circuit entered in the above case on May 15, 1985, and the denial of the Bank's Petition for Rehearing entered on July 5, 1985, or for summary reversal with reinstatement of the District Court's opinion and judgment.

OPINIONS BELOW

The opinion of the United States Court of Appeals for the Eighth Circuit (Ap. A) is reported as *Metge v. Baehler,* 762

F.2d 621 (1985). The opinion of the Hon. William C. Stuart Chief Judge of the United States District Court for the Southern District of Iowa (Ap. B) is reported as *Metge v. Baehler*, 577 F.Supp. 810 (S.D. Iowa 1984).

JURISDICTION

The judgment of the Court of Appeals was entered on May 15, 1985, and the Bank's Petition for Rehearing was denied on July 5, 1985. The jurisdiction of this Court is invoked under 28 U.S.C. §1254(1).

STATUTES AND REGULATIONS INVOLVED

Section 10(b) of the Securities Act of 1934, 15 U.S.C. §78j states:

> It shall be unlawful for any person, directly or indirectly***
>
> * * *
>
> (b) To use or employ, in connection with the purchase or sale of any security * * * any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe* * *.

Rule 10b-5 of the Securities Exchange Commission states:

> Employment of manipulative and deceptive devices.
>
> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

STATEMENT

Statement of the Case

This is a class action on behalf of holders of Thrift Certificates issued by Investors Mortgage & Finance Co. ("IMF") and guaranteed by its parent, Investors Equity, Inc. ("IEI"). The defendants are 17 former officers and directors of IEI, IMF and Bankers Trust Company, a banker-lender of IEI. All defendants are alleged to be liable as aider-abettors of the primary violation by IEI and IMF under § 10-b of the Securities Act of 1934 (15 U.S.C. § 78j) and Rule 10b-5 of the SEC, and controlling persons under § 20(a) of that Act.

Chief Judge Stuart of the Southern District of Iowa sustained the Bank's Motion for Summary Judgment as to both aiding-abetting and control person liability. He overruled the Motions of the other defendants. On appeal by plaintiff, the Eighth Circuit reversed Judge Stuart as to aiding and abetting liability of the Bank and affirmed as to control person liability.

Statement of Facts

The facts are most succinctly and accurately set forth in Judge Stuart's District Court opinion set forth in the Appendix. Only the facts relative to the alleged aiding and abetting liability of the Bank are here relevant. Extensive discovery has been completed. The facts are undisputed.

IEI was a small customer of the Bank for many years with good credit and a good record of payment. It was engaged primarily in the business of buying and selling real estate contracts.

The Bank had acquired the stock in Mid-Iowa Lakes ("MIL"), a wholly unrelated corporation, by foreclosure and sold this stock to IEI in 1971 for $820,000. The Bank loaned IEI $575,000 to acquire the stock. It is this loan which gives rise to the alleged aiding-abetting by the Bank.

In 1969, IEI had organized IMF, a subsidiary, which, among other activities raised capital by selling "Thrift Certificates" (sometimes in the record called "TC's") to the public through newspaper advertisements. These thrift certificates were unregistered securities and were not required to be registered by Iowa law. Their sale had been approved by the Iowa Securities Department. The thrift certificates were guaranteed by IEI which borrowed much of the money from the sales from its subsidiary, IMF.

Prior to 1972, IEI was in good financial condition with a net worth for the year ending September 30, 1972, of $934,000. The officers of the Bank testified that they had no real knowledge of IMF's thrift certificate sales and were only cognizant of them as a liability carried on IEI's consolidated financial statements. IMF which sold the certificates was not a customer of the Bank and did not maintain accounts at the Bank. All of the defendant officers and directors of IEI who testified by deposition indicated that the Bank had no involvement or knowledge of thrift certificate sales and had no knowledge or information as to what financial information was or was not furnished to prospective purchasers of thrift certificates except on one occasion where the Bank's trust department handled an exchange of two notes for thrift certificates and where financial information was furnished to the purchasers by IEI.

The Bank had no other knowledge about thrift certificate sales except what was contained in IEI's financial statements. They were never discussed with its customer, IEI. The Bank knew nothing about what representations or omissions were made to thrift certificate purchasers and had no knowledge of

the alleged violation which consisted of alleged misrepresentations in the newspaper advertisements and primarily in alleged omissions by failure to inform thrift certificate purchasers of IEI's true financial position. All of the officers of the Bank and all of the officers and directors of IEI who testified stated that no information was given to the Bank relative to what information was furnished to thrift certificate purchasers. Abstracts of the FBI's interview with Bank officers at the time of the bankruptcy of IEI before this lawsuit was filed indicate that the Bank had no knowledge of the manner of thrift certificate sales or the flow of IMF funds from thrift certificate sales. Proceeds from the sale of thrift certificates were deposited in IMF's account in another bank. These facts are uncontradicted.

IEI's financial position declined in 1973 due to the gasoline shortage and decline in recreational real estate values.

On May 10, 1974, a new Iowa law took effect requiring registration of thrift certificates. IEI was unable to secure additional financing to pay off existing thrift certificate holders and as a result went into bankruptcy in August of 1974.

The Bank lost $543,703 in principal on its loans to IEI and $107,809 in accrued interest. Other facts relating to alleged controlling person liability have been omitted.

REASONS FOR GRANTING THE WRIT

I. The Court Of Appeals For The Eighth Circuit Has Effectually Returned To The Negligence Standard[1] For Aiding-Abetting Liability in § 10-b Cases Under The Securities Act In Contravention Of *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 47 L.Ed.2d 688, 196 S.Ct. 1375 (1976) And As To Secondary Liability Of A Banker-Lender Has Created A Conflict With The Third Circuit In *Monsen v. Consolidated Dressed Beef Co.*, 579 F.2d 793 (3rd Cir. 1978) And The Fifth Circuit In *Woodward v. Metro Bank Of Dallas*, 522 F.2d 84 (5th Cir. 1975).

Introduction

The Eighth Circuit, by defining aiding and abetting a "fraud" to include not only knowledge that a *fraud* was being committed but also to include mere knowledge of the activity giving rise to the fraud, that is the sale of securities, has so expanded the concept of a violation of § 10-b that it again includes negligence. This, of course, is contrary to the principle enunciated by this Court in *Hochfelder, supra.* It has also ignored the well established rule that aiding-abetting liability requires a showing of substantial assistance *to the violation.*

This Petition is not a request for review of an evidentiary question, but rather consideration of whether a Circuit may redefine basic common law concepts and statutory requirements such as fraud and "manipulative and deceptive device or contrivance", and proximate cause, so that activity not heretofore thought to be fraudulent will be caught in the net of § 10-b liability. The Circuit Court has done this while giving lip service to *scienter* concepts required by *Hochfelder, supra,* and careful-

---

[1] Prior to *Hochfelder,* the Eighth Circuit had adopted a negligence standard in § 10-b securities cases in *Myzel v. Fields,* 386 F.2d 718 (8th Cir. 1967), *cert. denied,* 390 U.S. 951, 88 S.Ct. 1043 (1968).

ly enunciated by other Circuits. In addition, the Eighth Circuit has found a banker-lender to be an aider-abettor under circumstances directly contrary to the Fifth Circuit in *Woodward v. Metro Bank of Dallas, supra,* and the Third Circuit in *Monsen v. Consolidated Dressed Beef Co., supra.*

Elements of Aiding and Abetting A Securities Fraud

The three-pronged test for liability in aiding and abetting cases is well known and was first formulated in *S.E.C. v. Coffey,* 493 F.2d 1304 (6th Cir. 1974), *cert. denied,* 420 U.S. 908 (1975). It was followed in the leading case of *Woodward v. Metro Bank of Dallas,* 522 F.2d 84, 94 (5th Cir. 1975), by the Second Circuit in *Rolf v. Blyth Eastman Dillon & Co.,* 570 F.2d 38, 47 (2nd Cir. 1978), and again in *IIT v. Cornfeld,* 619 F.2d 909, 922 (2nd Cir. 1980), and by the Thrid Circuit in *Monsen v. Consolidated Dressed Beef Co.,* 579 F.2d 793, 799 (3rd Cir. 1978).

The test was followed by the Eighth Circuit in *Stokes v. Lokken,* 644 F.2d 779 (8th Cir. 1981) which states it to be:

> 1. The existence of a Securities law violation by the primary party (as opposed to the aiding and abetting party);
>
> 2. "Knowledge" *of the violation* on the part of the aider and abettor; and
>
> 3. "Substantial assistance" by the aider and abettor *in the achievement of the primary violation.* (Emphasis supplied).

For purposes of this appeal, the Bank admitted there was a fact question as to the existence of a securities law violation, but denied that there was any evidence of knowledge of the violation or of substantial assistance to the violation.

Knowledge of the Violation

In its opinion, the Eighth Circuit correctly found that in the absence of a duty, the plaintiff must demonstrate "that the aider-abettor consciously intended to assist in the perpetration of wrongful acts". It further found that *scienter* of the "high conscious intent variety" must be proved and states that "inaction must be accompanied by *actual knowledge* of the underlying fraud *and intent to aid and abet a wrongful act*". (Emphasis supplied).

The error of the Eighth Circuit lies in finding that mere knowledge of the Bank of the selling of thrift certificates, coupled with knowledge that its customer was in a declining financial position, constitutes actual knowledge of fraud. This, of course, is not the law; such knowledge alone is not knowledge of fraud. It was not unlawful or fraudulent for IEI and IMF to sell securities under Iowa or federal law, and it was not unlawful or fraudulent for them to sell such securities even when they were in poor financial condition so long as they made full disclosure of their financial condition and all of the circumstances to the purchasers. It was not fraudulent to use the proceeds of the sale of thrift certificates to redeem earlier thrift certificates so long as these circumstances and facts were fully revealed to the purchasers. The fraud, if any, arose from failure to disclose. The Eighth Circuit, however, finds the issue to be "...whether the bank understood that the thrift certificates were worthless and as a result prolonged the business lives of IEI and IMF for its own benefit at the expense of the thrift certificate holders". This is not the issue. The issue is whether there is substantial evidence that the Bank had "actual knowledge" of what information was and was not given to thrift certificate purchasers. The Eighth Circuit examined the status of thrift certificates to determine the "likelihood that BTC [the Bank] had actual knowledge of their importance to IEI as its financial fortunes worsened". Actual knowledge of the Bank about the importance of the thrift certificates is not an

issue. It is irrelevant. The actual knowledge required is knowledge of fraudulent selling; sale without disclosing relevant information. There is no evidence of this whatsoever and the Eighth Circuit cites none. The Eighth Circuit has made knowledge of the activity itself, selling thrift certificates, equivalent to knowledge of fraud when there is no evidence that the Bank had any knowledge that a fraud or violation of § 10-b was occurring.

The Eighth Circuit cites "two incidents from which a trier of fact might have inferred that BTC had actual knowledge of the existence and extent of the thrift certificate program". This may be true, but again the Bank's knowledge of the "program" is irrelevant. This knowledge can be inferred merely by Bank officers looking at the financial statements. This is not evidence of knowledge of the fraud. The first incident cited is an exchange by the Bank's trust department as escrow agent of two notes of another company for thrift certificates of IMF which the Eighth Circuit says confirms "BTC's knowledge of the program". The Bank's knowledge of the program is admitted. The Eighth Circuit does not note that at the time of that exchange, IEI did furnish financial statements to the two noteholders - a fact admitted by plaintiffs. This not only does not show knowledge of fraud but, to the contrary, shows only that the Bank at the time had no reason to suspect that a "violation" was occurring.

The second incident mentioned is a deposit made by Mr. Pappas (the Bank's loan officer) of funds from IMF, IEI's subsidiary which was selling the thrift certificates. The Eighth Circuit states that this is "potentially probative of BTC's acutal knowledge". The Bank's actual knowledge of what? It is probative of the Bank's actual knowledge that thrift certificate proceeds *may* have been used to pay the Bank, but this is not knowledge of fraud. There is nothing improper about using thrift certificate proceeds to make a bank payment. It is only actual knowledge that IMF was selling thrift certificates without

furnishing adequate financial information that would have been improper and would fasten aiding-abetting liability on a secondary person. There is no evidence of this. The Eighth Circuit's redefinition of fraud would make the Bank liable for simple negligence. This is plain error.

Substantial Assistance to the Fraud

The third element for aiding and abetting liability on which all Courts agree, including the Eighth Circuit, is that there must be evidence of substantial assistance to the violation by the alleged aider-abettor. The substantial assistance must be *to the violation* or fraud and not merely to the entity perpetrating the fraud. The Eighth Circuit overlooks this distinction. Although the Circuit approves of the proximate cause test used by Judge Stuart and other Courts to determine substantial assistance to the fraud it cites no evidence of how the Bank intended "to aid and abet a wrongful act". (Cir. Op. p. 6, A-6), Plaintiffs relied upon the allegation that the Bank "kept IEI afloat" by not foreclosing on its loans as constituting substantial assistance and this theory appears to be adopted by the Circuit. The Circuit notes "an unusual pattern of attempts to prolong IEI's financial viability". Is it substantial assistance *to a fraud* for a banker not to close down a customer's business when it is in financial difficulty? This is a strange rule; it is not even recklessness or negligence. Such a rule will only harm other creditors, including certificate holders. The Circuit Court equates assistance to the customer with assistance to the fraud, a concept properly considered and rejected by Judge Stuart. No Court in the country has heretofore held that assistance to the violator constitutes assistance to the fraud. Attempting to construe it as assistance to the fraud is a "but for" causation concept repudiated by all the Courts. Judge Stuart's scholarly analysis of the substantial assistance element of the case is not addressed by the Eighth Circuit, except to say that the evidence of substantial assistance is "slim". In fact, it is non-existent. Defining substantial assistance to the fraud as assistance to the violator in the ordinary course of business is clear error.

Conflicts With Other Circuits

The Eighth Circuit opinion is in conflict with *Woodward v. Metro Bank of Dallas, supra.* The Petitioner will not here analyze that case in detail, but suffice it to say that on facts much more favorable to the plaintiff than here, the Fifth Circuit found that there was no aiding and abetting of a securities fraud by a banker-lender. *Woodward* is the leading case in this area.

The opinion of the Eighth Circuit is also in conflict with *Monsen v. Consolidated Dressed Beef Co., supra.* In *Monsen* the Third Circuit did find aiding and abetting on the part of the bank and it is the only Circuit Court case so finding as to a banker-lender. In that case there was direct testimony and an admission of the bank officers that they not only knew that financial information was not being disclosed to the purchasers of securities, but that the bank had required that sales of securities continue and that they be subordinated to the bank's loan. In *Monsen* the securities were required to be registered under state law and were not. That is not the case here. None of the *Monsen* elements are present here and yet the Eighth Circuit Court found that mere knowledge of the sale of securities constitutes knowledge of the violation and that assistance to the violator in the form of forebearing from foreclosing or calling a loan constitutes substantial assistance.

The Bank does not contend that the Eighth Circuit's opinion here is in direct conflict with *Woodward* and *Monsen* on the legal maxims for aiding-abetting liability but it does submit that viewed in context the *Metge* decision permits a finding of aiding-abetting a fraud on facts which simply have never been considered to be aiding-abetting fraud and, thus, opens the door to liability based on negligence. In this sense, the decision is in conflict with the Second and Fifth Circuits and with *Hochfelder.*

Conclusion

It must be noted that unlike *Hochfelder,* there was no active fraud here; it was not a deliberate Ponzi scheme. At most it was a passive violation by IEI. It must also be noted that absolutely contrary to the Eighth Circuit's statement, the securities (thrift certificates) were not "worthless" when sold. There is no evidence of this. This is merely a word that the Circuit Court has casually picked up from Plaintiff's inaccurate brief. According to Coopers & Lybrand's certified audit, IEI had a net worth of $500,000 on September 30, 1973, seven months before certificate sales terminated; thus it could have paid off all certificate holders, other creditors and the Bank, even if its assets were overstated by half a million dollars. This is uncontroverted. The trustee in bankruptcy, in fact, paid a small dividend to the certificate holders even after the assets of IEI had been liquidated. The thrift certificates were not worthless. Here the Bank, an alleged aider-abettor, sustained a very substantial loss (a fact not present in *Woodward* or *Monsen*) and now may be found liable by a jury sympathetic to the certificate holders for in excess of an additional $3,000,000. None of the other defendants can pay such judgment. This outrageous result would be predicated on an erroneous concept of law.

Judge Stuart has presided over this case for over nine years. There are more than 9,000 pages of depositions and 13,000 documents. He is thoroughly familiar with the IEI, IMF and MIL bankruptcies. He wrote an opinion enjoining Robert Baehler, President of IEI, from selling securities. (S.E.C. v. Baehler, (unreported)). He wrote a careful and well-reasoned opinion here based on existing precedent and the undisputed facts. Now this has been brushed aside by a poorly-reasoned opinion which gives a new definition to fraud, ignores uncontroverted facts, and overlooks its own rule (*Stokes v. Lokken, supra*) that knowledge of an aider-abettor must be "knowledge *of the violation*" and not merely knowledge of the sale, and that substantial assistance must be *to the violation,* not merely to the violator generally.

In summary, if the test is that the Bank must have "consciously intended" to assist in the fraud and have had "actual knowledge" of the fraud, as both the Eighth Circuit and Judge Stuart correctly held, then there is simply no evidence of such conscious intent or actual knowledge. The Eighth Circuit cites none. *Plaintiffs did not even contend that the Bank had such knowledge or intent in the District Court.* Rather, they asserted that the Bank "must have known" of the violation; but this, as Judge Stuart pointed out, is insufficient in the absence of a duty of the Bank and under the undisputed facts. In the District Court, Plaintiffs did not contend that the Bank had a duty to disclose but relied on "recklessness".[2] When they found that recklessness is insufficient in the absence of a duty, Plaintiffs claimed for the first time before the Circuit Court that a duty arose from the Bank's position as a controlling person. Both Judge Stuart and the Circuit rejected Plaintiffs' controlling person argument.

The net result of the Eighth Circuit's opinion in this case is to modify the three-pronged aiding-abetting test adopted by several Circuits to be:

1. The existence of a securities law violation by the primary party;

2. Knowledge on the part of the aider-abettor that the primary violator is selling securities ("knowledge of the program". (8th Cir. Op. p. A-13), and

3. Substantial assistance to the general business activities of the violator by the aider-abettor.

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[2] This Court in Footnote 12 of *Hochfelder* did not address the question of whether in some circumstances reckless behavior is sufficient for liability under § 10-b and rule 10-b(5). However, since that time, several Circuits have determined that recklessness is sufficient for a primary violator who owes a duty to the plaintiff, but is not sufficient for a person alleged to be secondarily liable where no duty is owed. *Edwards & Hanly v. Wells Fargo Sec. Clearance Corp.*, 602 F.2d 478, 484 (2nd Cir. 1979); *Cleary v. Perfectune, Inc.*, 700 F.2d 774 (1st Cir. 1983); *IIT v. Cornfeld*, 619 F.2d 909, 922 (2nd Cir. 1980).

In both the second and third prongs, the key words of (or to) "*the violation*" have been omitted from the test. This is at the very most a negligence standard.

This Court has never considered aiding-abetting liability in a securities fraud context or whether and under what circumstances recklessness may be the basis for *scienter* and this would be a very appropriate case in which to do so. Such consideration would be of immeasurable assistance to the Bench and Bar and would assist in keeping securities fraud litigation in bounds.

It is extremely important that this Court maintain the rule enunciated in *Hochfelder* and not permit the rule to be diluted to extend § 10-b liability far beyond what Congress intended. If the rule stated by the Eighth Circuit is permitted to stand, banker-lender will become the virtual insurors of any customer selling securities and will require banks to foreclose at the earliest sign of trouble, to the detriment of security holders and other creditors.

A simple reading of Judge Stuart's opinion together with that of the Eighth Circuit and *Woodward* and *Monsen* as well as a knowledge of *Hochfelder* should suffice to require summary reversal. Petitioner respectfully submits that this Court should either grant *certiorari* or summarily reverse and reinstate the opinion and judgment of the District Court.

Respectfully submitted,

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APPENDIX

APPENDIX A

UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

No. 84-1201

Thelma T. Metge, Executrix of
the Estate of August Metge, and
Elizabeth G. Shepard, on behalf
of themselves and on behalf of
all others similarly situated,
Appellants.

v.

Robert L. Baehler, John E.
Gustafson, Richard Pigott,
Abe Clayman, H. Dale Bright,
Allen R. Loomis, Robert E. Boyt,
Albert W. Moritz, R. D.
Needham, Carl Redding, John S.
Rice, DeWayne Trask, Marlow
Samuelson, Bonnie Weaver,
Lloyd Jackson, John Fereday,
E. J. Sprengeler,
Bankers Trust Company,
Appellee.

Appeal from the United States
District Court for the
Southern District of Iowa.

Submitted: December 12, 1984

Filed: May 15, 1985

Before HEANEY, BRIGHT and ROSS, Circuit Judges.

HEANEY, Circuit Judge.

In this securities fraud class action, the district court granted Bankers Trust Company's (BTC) motion for summary judgment. Appellant Thelma Metge appeals on behalf of herself and 635 others similarly situated, arguing that the district court erred on the facts and law regarding BTC's liability as a controlling person and as an aider and abettor, and that the district court abused its discretion in dismissing pendent state claims against BTC. We affirm on the controlling person issue, but reverse and remand on the issues of aiding and abetting and pendent jurisdiction.

I. BACKGROUND.

Investor's Equity, Inc. (IEI), is an Iowa corporation which originally was involved in the business of buying, selling, and servicing real estate contracts on low-cost homes. Fluctuating business conditions in 1969 caused IEI to form Investor's Mortgage and Finance Company (IMF) to raise capital for IEI by selling unregistered, unsecured, one-year renewable securities called thrift certificates (certificates), which resembled promissory notes. Subsequently, IEI also issued thrift certificate guaranty bonds, which unconditionally guaranteed the certificates. Initially IMF transferred proceeds from certificate sales to IEI in exchange for IEI real estate contracts; but by the end of 1970, IMF was loaning the certificate proceeds to IEI in exchange for IEI's unsecured promissory notes. Certificate sales were brisk and by mid-1974, the outstanding balance had risen to $1.5 million.

IEI invested the certificate proceeds in speculative real estate ventures which, by 1971, began to erode IEI's financial standing. Over time, certificate proceeds grew, representing a larger share of IEI's financing. Meanwhile, BTC had become heavily involved in financing IEI, and engaged in a series of banking strategies which kept IEI in business. By mid-1974, however, the State of Iowa prohibited the sale and renewal of

unregistered thrift certificates. In August, 1974, IEI declared bankruptcy; as a result, certificate holders received only twelve and one-half cents on each dollar of accrued interest and no repayment of principal. BTC lost $543,703 in principal and $107,807 in accrued interest on its loans to IEI and its subsidiaries.

The appellant class of certificate holders sued BTC and seventeen individual appellees in federal district court, alleging state common law fraud and violations of federal securities laws stemming from misrepresentations and nondisclosure of relevant facts in connection with the sale of securities. In their federal securities law count, the appellants maintained that BTC is liable for violations of section 10(b) of the Securities Exchange Act of 1934 (15 U.S.C. § 78(j)) and Rule 10b-5 (17 C.F.R. § 240.10b-5) on theories of aiding and abetting, conspiracy and controlling person liability. The district court granted summary judgment for appellees, and the appellants appeal on all grounds except the conspiracy theory. We consider each of these arguments in turn.

II. THE AIDING-AND-ABETTING THEORY OF LIABILITY UNDER SECTION 10(b) AND RULE 10b-5.

A. Legal Principles of Liability.

This Court has previously set forth a three-pronged test to establish aiding-and-abetting liability. These requirements include:

> (1) the existence of a securities law violation by the primary party (as opposed to the aiding and abetting party);
>
> (2) "knowledge" of the violation on the part of the aider and abettor; and
>
> (3) "substantial assistance" by the aider and abettor in the achievement of the primary violation.

Stokes v. Lokken, 644 F.2d 779, 782-83 (8th Cir. 1981).

Because the theory of aiding-and-abetting liability is a matter of common law, the courts have not yet elaborated the full meaning of these factors. Nevertheless, certain aspects of the practical applications of these tests are clear. The factors—particularly the second and third—are not to be considered in isolation, but should be considered relative to one another. *Id.* at 784. Practically speaking, this means that "where there is a minimal showing of substantial assistance, a greater showing of scienter is required." *Id., citing Woodward v. Metro Bank of Dallas,* 522 F.2d 84, 95 (5th Cir. 1975). Thus, the two factors vary inversely relative to one another and where, as here, the evidence of substantial assistance is slim, the requirement of knowledge or scienter is enhanced accordingly.

The common law character of this three-part test requires further elaboration of the law before we apply the legal test to the facts of this case. Regarding the first prong of the test, we note that the existence of an underlying securities law violation by the primary party is not at issue in this case. Although BTC does not concede the existence of a violation, it recognizes that the appellants adduced sufficient evidence to give rise to a question of fact, which relieves us of further inquiry on this issue.

Regarding the "substantial assistance" factor, we note that the district court properly held that the appellants had the burden of showing that the secondary party proximately caused the violation. In approving this standard, we rely on decisions in other courts that have required a showing of "substantial causal connection between the culpable conduct of the alleged aider and abettor and the harm to the plaintiff[,]" *Mendelsohn v. Capital Underwriters, Inc.,* 490 F. Supp. 1069, 1084 (N.D. Cal. 1979), or a showing that "the encouragement or assistance is a substantial factor in causing the resulting tort[.]" *Landy v. Federal Deposit Insurance Corporation,* 486 F.2d 139, 163 (2d Cir. 1974), *cert. denied,* 390 U.S. 951 (1975) (quoting Restatement of Torts § 436.)

In further examining the "substantial assistance" requirement, we note that BTC's involvement amounted to inaction rather than positive deeds of manipulation or deception. The distinction between positive action and deliberate inaction is elusive, and we do not wish to foreclose appellants' strategies on remand, but the facts suggest that we examine the standard as it relates to substantial assistance through inaction.

Although courts are by no means unanimous in treating the question of substantial assistance in a case of inaction, most seem to agree that, if the aider and abettor owes the plaintiff an independent duty to act or to disclose, inaction can be a proper basis for liability under the substantial assistance test. *E.g.*, *Cleary v. Perfectune,* 700 F.2d 774, 777 (1st Cir. 1983) (citing cases which impose a duty to disclose where defendant possesses insider information, where a controlling person approves fraudulent practices, or where the law imposes special obligations on a profession). We find no such duty in this case. Nevertheless, the district court properly applied an exception to this rule in deciding the case under the so-called *Woodward-Monsen* rule. In *Monsen v. Consolidated Dressed Beef Co., Inc.,* 579 F.2d 793 (3d Cir. 1978), *cert. denied,* 439 U.S. 930 (1979), the Third Circuit evaluated the substantial assistance requirement in a case of inaction and concluded that inaction "may provide a predicate for liability where the plaintiff demonstrates that the aider-abettor *consciously* intended to assist in the perpetration of the wrongful act." *Id.* at 800 (emphasis in original). The Fifth Circuit took a similar tack in *Woodward v. Metro Bank of Dallas,* 522 F.2d 84 (5th Cir. 1975):

> When it is impossible to find any duty of disclosure, an alleged aider-abettor should be found liable only if scienter of the high "conscious intent" variety can be proved. Where some special duty of disclosure exists, then liability should be possible with a lessor degree of scienter.

Id. at 97 (footnote omitted).

Simply put, in the absence of a duty to act or disclose, an aider-abettor case predicated on inaction of the secondary party must meet a high standard of intent. As applied here, *Woodward* and *Monsen* require that the aider-abettor's inaction be accompanied by actual knowledge of the underlying fraud and intent to aid and abet a wrongful act. The requisite intent and knowledge may be shown by circumstantial evidence. *Woodward,* 522 F.2d at 96.[1]

B. Application of the Law to the Facts.

At the outset, we note the standard governing reliance on inferences in a summary judgment motion: direct proof is not required to create a jury question, but to avoid summary judgment, "the facts and circumstances relied upon must attain the dignity of substantial evidence and not be such as merely to create a suspicion. * * * Furthermore, an inference which a jury is entitled to draw must be based upon proven facts and not upon other inferences." *Impro Products, Inc. v. Herrick,* 715 F.2d 1267, 1272 (8th Cir. 1983), *cert. denied,* 104 S.Ct. 1282 (1984), citing *Admiral Theatre Corp. v. Douglas Theatre Co.,* 585 F.2d 877, 884 (8th Cir. 1978).

In evaluating the record under this standard, we must determine whether the bank understood that the thrift certificates were worthless and, as a result, prolonged the business lives of

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[1] Because the circumstances in this case dictate the high scienter standard, we leave open the question of whether other facts in another case with more substantial assistance might state a claim under a recklessness standard of scienter. *See Ernst & Ernst v. Hochfelder,* 425 U.S. 185, 194 n.12 (1976). Other circuits have limited the applicability of recklessness as a scienter requirement to cases in which the secondary party owed the plaintiff a duty. *Cleary v. Perfectune,* 700 F.2d 774, 777 (1st Cir. 1983); *Edwards & Hanly v. Wells Fargo Securities Clearance Corp.,* 602 F.2d 478, 484 (2d Cir. 1979), *cert. denied,* 444 U.S. 1045 (1980); *Woodward,* 522 F.2d at 97.

IEI and IMF for its own benefit at the expense of the certificate holders. Although we express no view of the outcome of this case on the merits, careful review of the record convinces us that the appellants adduced sufficient evidence to avoid a summary judgment.

To explore the question of BTC's knowledge, we initially examine the nature of the relationship between BTC and IEI. The relevant history began in 1970 when BTC acquired by foreclosure a controlling block of stock in Mid-Iowa Lakes Corporation (MIL), which developed recreational real estate outside Des Moines, Iowa. Later that year, BTC, along with an Omaha bank, loaned MIL nearly $1.5 million in an attempt "to keep everything afloat."

In February, 1971, BTC sold the MIL stock to IEI under innovative terms, which figure prominently in this litigation. The total value of the transaction was $950,000, of which IEI paid $130,000 in cash. In addition, IEI gave BTC a $575,000 collateral pledge note for the acquisition loan, 50,000 shares of IEI stock, an irrvocable proxy to vote the MIL stock (the MIL stock was registered to IEI with blank stock powers back to BTC), and a guaranty of the acquisition loan by IEI directors and officers totaling $440,000. The 50,000 shares of IEI stock (the largest block of outstanding IEI stock, amounting to seventeen to eighteen percent of total shares) were transferred to Bell and Company, which was a partnership of senior BTC officers.

The proxy held by BTC in the MIL stock was unlimited and irrevocable. It was qualified, however, in that the purchase agreement included a proviso that BTC could only vote the stock when IEI was in default on its payments under the purchase agreement. IEI was frequently behind in its payments, which gave BTC at least potential control virtually from the outset of the agreement. Because the proxy allowed BTC to vote a controlling share of MIL stock, it gave BTC potential control over the general business affairs of MIL; for instance, it

could call shareholder meetings, influence the composition of the board of directors, and amend articles and by-laws.

The purchase agreement also included a provision which empowered BTC to "put" or sell IEI stock back to IEI at a rate higher than BTC had paid for the stock. Thus, BTC was protected against the vagaries of the market, for if the stock value did not increase, IEI could be compelled to repurchase it at a higher price, but if the stock's value rose, BTC could sell it in the open market at a profit.

As part of its lending relationship with IEI, BTC also arranged to receive regular financial reports on IEI and MIL. Although in 1972 they were initially receiving quarterly statements (which showed quarterly balances of outstanding thrift certificates), by 1973, BTC was also receiving unaudited financial statements which treated IEI on a separate consolidating basis and revealed large thrift certificate balances.

An account of BTC's relationship with IEI must also consider the measures that BTC undertook to perpetuate IEI's business life. Viewed separately, most of these banking transactions are unremarkable events in the turbulent economy of the early seventies; but viewed in conjunction with the other evidence we discuss, they suggest an unusual pattern of extraordinary attempts to prolong IEI's financial viability.

Under the terms of the MIL acquisition loan, IEI was obligated to make a $100,000 downpayment, followed by $23,000 quarterly payments until September, 1972, when the loan would be repaid with a large balloon payment. When the first quarterly payment came due, however, IEI's poor cash flow compelled it to default, as it also did on the second payment. After extending the deadlines several times, BTC recognized that IEI was in part hampered by its involvement in another recreational real estate project, and so to recover its quarterly payments and to secure prepayment of the third quarterly payment, BTC arranged a "take-out loan" of

$200,000 for the other project and IEI made its first three payments on the original acquisition loan.[2]

In April, 1972, BTC acted as escrow agent for IEI in an exchange of other obligations for thrift certificates and thrift certificate guaranty bonds. IEI had previously purchased the assets and liabilities of the Triple Eye Corporation, which obligated it on certain outstanding notes. Working through BTC and with the approval of BTC's president, IEI offered to exchange its thrift certificates and guaranty bonds for the notes. Two noteholders, who are members of the appellant class, accepted the offer, sent their notes to BTC and received IEI's thrift certificates and guaranty bonds from BTC in exchange. In deposition, bank officers stated that this was a standard service offered by the bank's trust department. Nevertheless, the bank's role in the exchange is relevant at least in demonstrating its awareness of IEI's reliance on the thrift certificate program in April, 1972.

In late September, 1972, after other late quarterly payments and discussion of exercising the "put" on the IEI stock and of seeking protection from the guarantors of the MIL acquisition loan, BTC agreed with IEI to renew and amend the terms of the loan agreement. Under the revised agreement, IEI was obliged to make an immediate $30,000 payment on the MIL acquisition loan, with the due date on the balance extended to October, 1974, on a new nine percent note. In addition, the bank attached an eleven percent service charge to the "put" because, according to BTC president Robert J. Sterling, the "put" represented a debt on which the bank made no interest or earnings if the "put" was not exercised. The "put" was additionally secured

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[2] Because of title problems and construction delays, the other IEI project was never funded, and that division of IEI went bankrupt. Depositions of bank officers indicate, however, that they did not trace the delinquent payments to the take-out loan; according to BTC loan officer Chris Pappas, it is not banking practice to question the source of the payments "when you get paid."

by stock of another IEI subsidiary and by mortgages on some IEI real estate. IEI also agreed to provide monthly, rather than quarterly, consolidating statements for itself and each of its subsidiaries, and it also agreed to refrain from borrowing more than $100,000 from any other lenders without BTC's consent.

Refinancing became necessary in May, 1973, after IEI defaulted on two more note payments and on two of the "put" service charge payments. (It also defaulted on the next six payments due on both of these obligations, through at least April, 1974.) According to Sterling, the May, 1973, refinancing plan was intended "to keep all of this thing afloat." Under this new plan, IEI borrowed an additional $71,000 from BTC, which was used to satisfy delinquent loan payments and service charges. As collateral for the loan, IEI secured a $71,000 note from MIL. In addition, BTC required IEI to pledge additional MIL stock as collateral for a $100,000 obligation which had previously been unsecured. Although the $71,000 was a "wash" transaction, the application of the loan proceeds to delinquent payments brought IEI's obligations up to date and apparently protected BTC with more collateral. Unfortunately, in real terms, the refinancing plan did little to help keep IEI "afloat." On December 31, 1973, BTC was obliged to loan IEI an additional $69,000 on an "emergency" basis to pay delinquent taxes.

Yet by March, 1974, IEI was once again in serious financial trouble which required BTC's intervention in the form of a final refinancing plan resembling the plan which went into effect ten months before. When asked if BTC was very concerned about its position on certian loans to IEI, loan officer Chris Pappas replied, "That would be an understatement." As a result, IEI was obliged to sell a $13,000 receivable note and to pledge its interest in a plastics company to secure a previously unsecured loan. In addition, MIL issued a $25,000 note to IEI, which IEI pledged to cover the balance of the $71,000 loan in May, 1973. Finally, MIL borrowed $46,000 from BTC (which was secured

by receivables) which it paid to IEI which in turn paid to BTC (along with $16,000 in other funds) to bring IEI's obligations up to date. Thrift certificate sales ceased in May, 1974, and by the end of summer, IEI had filed for bankruptcy under Chapter 11.

We can only conclude from the above that several times BTC apparently rescued IEI and its subsidiaries from the brink of financial disaster with the declared objective of preserving the enterprises. The relevance of these banking decisions to the aiding-and-abetting issue becomes apparent when we review the extent of IEI's financial woes and of the extent to which it knew that IEI depended for cash on the sale of then-worthless thrift certificates.

In considering the financial data, the district court relied on IEI's consolidated balance sheets (which reflected the status of IMF and other subsidiaries) prepared in March, 1974, and concluded that IEI had a net worth of $975,000 at the end of fiscal 1972 and $500,000 at the end of fiscal 1973. While these figures, as far as they go, appear to be correct, a proper consideration of the existence of a jury issue on this question requires a more thorough analysis of IEI's financial outlook. When the net worth figures are considered along with certain qualifications and with other relevant figures, IEI's future looks considerably bleaker, and BTC's banking decisions are cast in a different light.

First, we review the assumptions and qualifications embodied in the net worth figures. At the deposition to which the appellees refer in their brief, the net worth figure is qualified by the assumption that the assets could be sold at the stated value and that the net worth figure is also subject to contingent liabilities cited in the balance sheets. Moreover, Coopers and Lybrand, IEI's accountants, prepared the balance sheets on a "going concern basis" which "contemplates the realization of assets and liquidation of liabilities in the ordinary course of business. * * * [T]he Company has not generated sufficient

revenue to cover all items of expense and to liquidate liabilities in accordance with the terms of such liabilities. The Company's ability to retain the assets which are pledged as collateral for the notes which are in default and the continuation of operations depends upon achieving profitable operations and retaining additional and/or continued financing." According to Coopers and Lybrand, the figures were also subject to "(1) the Company's achieving profitable operations and obtaining additional and continued financing, and (2) any possible adjustment arising from the determination of the disputed liabilities and related litigation and fiscal acceptance of a subsidiary utility company's rates[.]" These assumptions throw the net worth figures in considerable doubt as regards the jury issue.

Yet perhaps more important, the net worth figures contrast with other less optimistic measures of IEI's economic vitality which were included in the March, 1974, report and preceding reports. We note that IEI's net loss was $151,346 in fiscal 1971, which more than doubled to $311,611 the following fiscal year, and increased to $365,101 for fiscal 1973. In addition, the March, 1974, report noted that IEI lost its office building for failure to keep the mortgage current and that IEI lost its rights on two leases on undeveloped property due to nonpayment of rent on the land leases.

We also note that, in previous years, BTC had performed its own analysis of IEI's audited financial statements and found that IEI faced difficult economic problems. As early as February 10, 1972, BTC concluded that, for fiscal 1971, IEI exhibited an assets-to-liabilities ratio of .236 to 1 ($905,000 to $3,840,400), and a borrowing ratio of 8.70 to 1, based on liabilities of $10,933,900 and a capital structure of $1,257,300. By March, 1973, BTC's spread sheets on IEI's financial status revealed that the assets-to-liabilities ratio had improved to 1.09 to 1, but that its borrowing ratio had increased to 13.26 to 1. BTC concluded that the latter ratio showed "that the Company is under extreme pressure and Company leverage for creditors is

extremely limited." Significantly, BTC loan officer Chris Pappas testified in deposition that these ratios — assets to liabilities and debt to worth — are the "most important" ratios on the spread sheets.

In evaluating these data and the relationship between BTC and IEI, we analyze finally the status of the thrift certificates to determine the likelihood that BTC had actual knowledge of their importance to IEI as its financial fortunes worsened. Careful review of the deposition testimony of BTC officers reveals that they deny all knowledge of the thrift certificates, of the fact that they were secured by real estate, and of the possibility that thrift certificate proceeds were the essential means by which IEI stayed alive and was able to make any payments on its obligations to BTC.

Due to comingling of accounts and the difficulty of tracing funds to their sources, little evidence actually documents the transfer of thrift certificate proceeds to BTC in satisfaction of IEI's obligations. Nevertheless, we find noteworthy two incidents from which a trier of fact might have inferred that BTC had actual knowledge of the existence and extent of the thrift certificate program. First is the Triple Eye Corporation's note exchange in April of 1972, which we previously discussed. BTC president Robert J. Sterling approved the bank's role as escrow agent in handling the exchange of the Triple Eye notes for IEI thrift certificates and BTC's trust department handled the matter. Although only two members of the plaintiff class were involved in the exchange, the incident could be interpreted as confirming BTC's knowledge of the program.

The second incident involves thrift certificate proceeds received by loan officer Chris Pappas on September 30, 1972, as part of the renewed and amended loan agreement between BTC and IEI. The record reflects that Pappas received a hand-delivered $30,000 check from IMF made payable to IEI, and IEI deposit slip for the $30,000 check, and an IEI check for $30,000 payable

to BTC. He signed a receipt for the deposit and personally credited the IEI account for the following business day. Although Pappas argued in deposition that he did not make the connection between the deposits and thrift certificate proceeds until he was asked about it during the deposition, we regard the evidence of the transaction as potentially probative of BTC's actual knowledge as we survey the totality of the evidence.

The other set of circumstances surrounding the thrift certificate program that we regard as important in evaluating the propriety of the summary judgment is the growth in thrift certificate sales relative to IEI's declining financial health. We believe that records available to BTC confirm that these developments were inversely correlated—the worse things got for IEI, the higher were its thrift certificate proceeds. For instance, according to the balance sheet for fiscal 1971, while IEI's financial condition worsened, outstanding thrift certificates totaled $392,100, which was over three times the balance of the previous fiscal year. By March, 1972, as IEI's woes worsened, the total had risen to $482,950, and a September "Cash Flow Projection" assumed continued sales of at least $15,000 per month. By March of 1973, outstanding thrift certificates reached $694,970 and at the time of IEI's bankruptcy, they totaled nearly $1.5 million. Thus, the impressive growth in thrift certificates is a nearly perfect reciprocal of IEI's downward-sloping path, which we recounted earlier.

The final inquiry we make in evaluating the relationship between BTC and IEI involves the extent to which BTC can be showed to have benefited from postponing IEI's bankruptcy. Although it is undisputed that BTC lost over $650,000 in principal and accrued interest due to IEI's insolvency, *Metge,* 577 F. Supp. at 814, we believe that this figure should not be the end of the inquiry, for the loss must be placed in context. First, we note that holders of thrift certificates, who were entitled to $1.5 million of principal, received none of their principal and only twelve and one-half cents of every dollar of accrued interest.

Moreover, BTC's initial exposure in its lending arrangement was $950,000, which, when compared with its loss, suggests that it received significant payments of principal and interest as well as the service charges it collected on the "put" arrangement after it renegotiated an eleven percent service charge in September, 1972. Thus, although the record is not very illuminating on the question of BTC's benefit from IEI's delayed bankruptcy, we find sufficient evidence at least to give rise to an inference that BTC may have benefited at the expense of the certificate holders from IEI's renewed lease on life.

Although the facts we have recounted here at length are unremarkable taken in isolation, we find that taken together, they present what should have been a jury issue on the question of aiding-and-abetting liability. In sum, we have remarked on an unusually favorable banking relationship between the two parties at a time when BTC knew of IEI's precarious financial position. Moreover, the evidence suggests that BTC had knowledge of the thrift certificate program and its importance to IEI's ability to repay BTC's loan to IEI. Finally, we find an inference arising from the evidence which suggests that, although BTC made no profit on its loans to IEI nor even recovered its outstanding funds by postponing IEI's demise, it may have been able to lever itself into a more favorable position than the holders of thrift certificates. We express no view of any likely outcome on the merits, but hold only that summary judgment at this stage of the proceedings appears to have been premature.

III. CONTROLLING PERSON LIABILITY.

A. The Applicable Legal Standard.

The appellants also contend that the district court erred in granting summary judgment in favor of the appellees on the issue of controlling person liability. Careful review of the legal and factual issues under this theory persuades us that the district court did not err.

Controlling person liability is predicated on 15 U.S.C. § 77o, which provides:

> Every person who, by or through stock ownership, agency, or otherwise, or who, pursuant to or in connection with an agreement or understanding with one or more other persons by or through stock ownership, agency, or otherwise, controls any person liable under sections 77k or 77l of this title, shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist.

Congress has provided little guidance for the courts in construing these sections, however, believing that strict definitions of control would be "undesirable" because "[i]t would be difficult if not impossible to enumerate or to anticipate the many ways in which control may be exerted." H.R. Rep. No. 1383, 73rd Cong., 2d Sess. 26 (1934). The SEC appears to have adopted a similar approach in formulating a broad definition of control as "[t]he possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise." 17 C.F.R. § 240.12(b)-2 (1983). Accordingly, we turn to the courts for guidance.

In *Myzel v. Fields,* 386 F.2d 718 (8th Cir. 1967), *cert. denied,* 390 U.S. 951 (1968), this Court observed that "[t]he statute is remedial and is to be construed liberally. It has been interpreted as requiring only *some indirect means of discipline or influence short of actual direction to hold a 'controlling person' liable." Id.* at 738 (emphasis added). We believe that the district court properly followed *Myzel's* direction for interpreting the statute.

The district court relied on *Stern v. American Bankshares Corp.*, 429 F. Supp. 818 (E.D. Wis. 1977), to formulate its controlling person test. The Stern court declared that, to establish a prima facie case of controlling person liability, the plaintiff must demonstrate that the purported controlling persons "actively participated in the operations of Bankshares and possessed actual control over the transaction in question. Once that is established, the matters of knowledge and actual participation, which directly or indirectly induced the fraud, are matters for the defense." *Id.* at 824.[3]

From Stern, and in compliance with this Court's guidance in *Myzel,* the district court formulated a two-point test under which plaintiffs must establish, first, that the defendant lender "actually participated in (*i.e., exercised* control over) the operations of the corporation in general; then he must prove that the defendant possessed the power to control the specific transaction or activity upon which the primary violation is predicated, but he need not prove that this later power was exercised." *Metge,* 577 F.Supp. at 817-18. We approve this test because it complies with precedents which counsel broad remedial construction of the statute and because it complies with precedents that distinguish between actual exercise of control in the violator's principal affairs and potential control over the violation.

Although other courts of appeals have adopted the more restrictive "culpable participation" requirement, which requires a showing that the lender actually participated in the alleged violation, *Rochez Brothers v. Rhoades,* 527 F.2d 880, 889-90

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[3] In part, the *Stern* court relied on *Holloway v. Howerdd, 377 F. Supp. 754, 761 (M.D. Tenn. 1973): "A director's liability [as a controlling person] * * * presupposes some extent of actual participation in the corporation's operation before the consequences of control may be imposed."*

(3d Cir. 1975); *Gordon v. Burr,* 506 F.2d 1080, 1085-86 (2d Cir. 1974); *see also Christoffel v. E. F. Hutton & Co.,* 588 F.2d 665, 668-69 (9th Cir. 1978) (discussing without deciding the relevance of the culpable participation standard), we reject this more stringent standard for reasons announced by the Fifth Circuit in *G. A. Thompson v. Partridge,* 636 F.2d 945 (5th Cir. 1981). That Court, citing the text of the statute and regulation we set out above, noted that the plain meaning of both texts does not require participation in the wrongful transaction. *Id.* at 957-58. In addition, good faith and lack of participation are affirmative defenses in a controlling person action, and requiring them as part of the plaintiff's prima facie case while allowing them as affirmative defenses, confuses the parties' responsibilities and unnecessarily burdens contrary to the plain meaning of the statute. *Id.; see also Metge,* 577 F. Supp. at 815-16. Accordingly, we find no error of law in the district court's formulation of the controlling person test.

B. Application of the Legal Standard to the Facts.

Due to the bifurcated nature of the district court's two-pronged test, we first consider whether the appellants introduced sufficient evidence of BTC's actual control over IEI's general affairs. Because we find this evidence to be insufficient, we need not consider evidence regarding BTC's potential control over the alleged violation.

The appellants insist throughout their brief that the facts that they cite must be considered against the backdrop that BTC was IEI's primary lender, with the ability to foreclose on the loans whenever IEI was delinquent on payment. The appellants cite several factors which they argue suggest actual control of IEI. First, BTC held seventeen to eighteen percent of IEI's stock, with the perquisites that accompany stock ownership (including the right to attend stockholder meetings, to vote its stock, and to receive stockholder communications). Second, BTC in-

fluenced the management of IEI's subsidiary, MIL, in that, as part of its security agreement on the acquisition loan, BTC held the proxy on a controlling block of fifty-one percent of MIL's voting stock; third, the "put" arrangement in the security agreement on the acquisition loan gave BTC power over IEI's policy regarding capital stock; fourth, BTC personnel attended a few MIL and IEI board meetings; fifth, BTC controlled IEI's operations through its innovative refinancing arrangements through which BTC influenced IEI's and MIL's debt structure by causing IEI to issue notes, sell its receivables and loan money to MIL. (We also consider as part of the record BTC's alleged receipt of financial reports and its performance of services as escrow agent in the exchange of the Triple Eye Notes.)

We agree with the district court that careful review of the record reveals no evidence which demonstrates actual control. At most, these facts suggest the *potential* for influence over some of IEI's business decisions, but they are not probative of appellants' allegation that BTC actually exercised control over the operation of the corporation in general. In fact, the evidence we have mentioned exemplifies the kind of evidence that might be adduced on the second prong of the test to demonstrate possession of power to control, rather than actual control.

IV. PENDENT JURISDICTION.

Because we find that the district court erred in granting summary judgment against the appellants on the aiding-and-abetting theory of liability, we also reverse on the dismissal of the pendent state claims of common law fraud. These state claims appear to arise out of a common nucleus of opertive fact, *United States Mine Workers v. Gibbs,* 383 U.S. 715, 725 (1966), and, in the interest of judicial economy, should be resolved with the primary federal claims.

Accordingly, the judgment of the district court is affirmed on the controlling person theory of liability, but is reversed and remanded on the aiding-and-abetting theory and on the pendent state claims.

A true copy.

Attest:

CLERK, U. S. COURT OF APPEALS, EIGHTH CIRCUIT.

APPENDIX B

IN THE UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF IOWA
CENTRAL DIVISION

Civil No. 76-213-1

Thelma Metge, Executrix of the
Estate of August Metge, and
Elizabeth G. Shepherd, on behalf
of themselves and on behalf of
all others similarly situated,
Plaintiffs,

vs.

Robert L. Baehler, et al.,
Defendants.

**RULING AND ORDER ON
BANKERS TRUST COMPANY'S
MOTION FOR SUMMARY JUDGMENT**

(Filed Jan. 9, 1984)

The Court has before it a motion for summary judgment filed by defendant Bankers Trust Company (BTC) on December 22, 1982. At the time BTC's motion was filed, this case had been transferred to the docket of the Hon. William C. Hanson, senior district judge, pursuant to an Order of the undersigned judge dated December 1, 1982. In an Order dated June 6, 1983, Judge Hanson transferred the case back to the undersigned judge after determining that he should disqualify himself from further participation in the case. This judge then held a hearing on BTC's motion on August 5, 1983, along with several other motions which remain pending.

I. **Plaintiffs' complaint.**

In their amended and substituted complaint filed September 23, 1982, plaintiffs assert claims against defendant BTC and seventeen individual defendants in three counts. Count I alleges misrepresentations and nondisclosure of material facts in connection with the sale of securities, in violation of the federal securities laws. Counts II and III are pendent state law claims based on the same basic set of factual allegations. Under Count I, plaintiffs seek to hold BTC liable for violations of Section 10(b) of the Securities Exchange Act of 1934 (15 U.S.C. § 78j) and Rule 10b-5 (17 C.F.R. § 240.10b-5) under three theories of secondary liability: (1) controlling person; (2) aiding and abetting; and (3) conspiracy. BTC seeks summary judgment on each of plaintiffs' claims.

II. **Factual background.**

Exhaustive discovery has been had in this case by plaintiffs and other parties. It can safely be said that most of the evidence relevant to BTC's motion is undisputed, and that the parties disagree primarily over the permissible inferences and legal conclusions to be drawn from the evidentiary facts. These issues will be discussed in further detail elsewhere, as will much of the evidence upon which the parties rely in support of their respective positions. At this point, the Court will simply provide a brief summary of the facts of the case as a context for further discussion.

This lawsuit arises out of the sale of "thrift certificates" (promissory note-type securities) by Investors Mortgage & Finance Co. (IMF) between April 1, 1970, and May 1, 1974, in the state of Iowa. The certificates were guaranteed by IMF's parent corporation, Investors Equity, Inc. (IEI), by means of guarantee bonds. Both corporations are now defunct.

Plaintiffs are individuals (or their successors in interest) who purchased IMF thrift certificates which were not redeemed before IEI filed for bankruptcy in August 1974. At the close of the bankruptcy proceedings in 1979, plaintiffs received only 12½ cents for each dollar of accrued interest owing them; the principal has never been repaid. The defendants in this action, other than BTC, are all former officers and/or directors of IEI and/or IMF. BTC is the sole corporate defendant.

IEI, which was formed in 1961, engaged mainly in buying and selling real estate contracts throughout most of the 1960s. In early 1969, IEI formed IMF, a wholly-owned subsidiary, primarily to raise capital for IEI to use in making new investments in recreational real estate. IMF was to raise this capital by selling thrift certificates.

At first, IEI obtained thrift certificates proceeds from IMF by selling real estate contracts to IMF. Beginning in December 1970, however, this practice ceased, and IMF began loaning thrift certificate proceeds to IEI in return for IEI's unsecured promissory notes. By the time bankruptcy proceedings began in 1974, the outstanding principal balance of thrift certificates and guarantee bonds totaled $1.5 million.

BTC was IEI's banker and primary lender throughout IEI's corporate existence. IMF, however, obtained no loans from BTC and had its bank accounts elsewhere. BTC was involved in a number of lending transactions with IEI and certain IEI subsidiaries other than IMF, but only one will be discussed in this general summary. In 1971, as a result of a foreclosure, BTC acquired the stock of Mid-Iowa Lakes Corp. (MIL), and then sold the stock to IEI. It was necessary for IEI to borrow money from BTC to complete the purchase. As part of the transaction, 50,000 shares of IEI common stock were transferred to BTC's nominee, Bell & Co., a partnership of BTC officers. The parties disagree as to whether the transfer was an outright sale or merely security for the loan. Although BTC urges that a finding of

the bankruptcy court is res judicata as to this question, this Court finds no need to resolve the parties' disagreement over the characterization of the stock transfer. However characterized, it is clear that legal title to the stock passed to BTC's nominee, giving BTC the power to vote 17-18% of the common stock of IEI. This was the largest single block of IEI stock.

As part of the MIL stock transaction, BTC also acquired an irrevocable proxy to vote the MIL stock. The proxy was to become effective only in the event that BTC declared a default by IEI on the MIL acquisition loan. Although IEI did become delinquent on the loan several times, BTC chose not to declare default but instead extended the note upon payment of interest by IEI.

Because of its lending relationship with IEI, BTC received IEI's annual consolidated financial statements. IMF's financial position was included therein but was not separately stated. Beginning in October 1973, BTC also received interim financial statements from IEI. IEI had suffered losses in 1973 due to the energy crisis and other problems which had caused declines in the recreational real estate business. These losses continued into 1974.

Another problem occurring in 1974 was the initiation of a new Iowa law requiring registration of thrift certificates effective May 10, 1974. Registration was not required prior to that date, and IMF's thrift certificates had never been registered. IEI officials discussed the upcoming change in the law with BTC in December 1973 and early 1974, expressing concern that registration would not be granted to IMF thrift certificates, that sales and renewals of the certificates would therefore cease, and that severe cash flow problems would result for IEI if existing certificates had to be paid off rather than renewed. These concerns became realities, and IEI was forced to file for bankruptcy. As a result of IEI's insolvency, BTC lost $543,703 in principal and $107,809 in accrued interest on its various loans to IEI.

III. **Law governing summary judgment.**

Part (c) of Fed. R. Civ. P. 56, the summary judgment rule, provides in part: "The judgment sought shall be rendered forthwith if the pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law."

Part (e) of Rule 56 provides in part:

> When a motion for summary judgment is made and supported as provided in this rule, an adverse party may not rest upon the mere allegations or denials of his pleading, but his response, by affidavits or as otherwise provided in this rule, must set forth specific facts showing that there is a genuine issue for trial. If he does not so respond, summary judgment, if appropriate, shall be entered against him.

The evidence must be viewed in the light most favorable to the non-movant, who is entitled to the benefit of all reasonable inferences to be drawn from the facts. McClain v. Meier, 612 F.2d 349, 356 (8th Cir. 1979).

Summary judgment is a drastic remedy, and the movant bears the heavy burden of establishing his right to judgment with such clarity as to leave no room for controversy and of proving that the non-movant could not recover under any discernible circumstances. Vette Co. v. Aetna Casualty & Surety Co., 612 F.2d 1076, 1077 (8th Cir. 1980). However, when appropriate, summary judgment fulfills the salutary purpose of avoiding useless and time-consuming trials. Butler v. M.F.A. Life Insurance Co., 591 F.2d 448, 451 (8th Cir. 1979).

IV. **Analysis.**

A. Controlling person liability.

Plaintiffs' "controlling person" claim against BTC is based on § 20(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78t(a), which provides:

> Every person who, directly or indirectly, controls any person liable under any provision of this title or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

Although there is general agreement as to the elements of proof under § 20(a), the Court's review of the case law indicates that there has not been uniform treatment concerning the party with the burden of proof on each element.

In Briggs v. Sterner, 529 F. Supp. 1155, 1170 (S.D. Iowa 1981), this Court stated that in order to prevail on a federal securities claim brought under § 20(a),

> a complainant must prove (1) the controlled person's acts or omissions constituting an infringement of the pertinent federal securities statute; (2) that the controlling person possessed either direct or indirect influence or power over the management of the controlled person; and (3) the statutory good faith defenses are not available to the controlling person once the existence of a control relationship is established.

To the extent that this information places upon the plaintiff the burden of proving the controlling person's lack of good faith under § 20(a), the Court concludes that it is incorrect.[1] Although there appears to be no Eighth Circuit case law which

specifically addresses the burden of proof question, cases from other jurisdictions uniformly indicate that the good faith and non-inducement component of jurisdictions uniformly indicate that the good faith and non-inducement component of §20(a) is an affirmative defense upon which the controlling person has the burden of proof. G.A. Thompson & Co. v. Partridge, 636 F.2d 945, 958 (5th Cir. 1981); Marbury Management, Inc. v. Kohn, 629 F.2d 705, 716 (2d Cir.), *cert. denied,* 449 U.S. 1011 (1980); Zweig v. Hearst Corp., 521 F.2d 1129, 1132 (9th Cir.), *cert. denied,* 423 U.S. 1025 (1975); SEC v. First Securities Co. of Chicago, 463 F.2d 981, 987 (7th Cir.), *cert. denied,* 409 U.S. 880 (1972); Leff v. CIP Corp., 540 F.Supp. 857, 867 (S.D. Ohio 1982); Haynes v. Anderson & Strudwick, Inc., 508 F.Supp. 1303, 1315 (E.D. Va. 1981); Savino v. E.F. Hutton & Co., 507 F.Supp. 1225, 1242-43 (S.D. N.Y. 1981); Kravitz v. Pressman, Frohlich & Frost, Inc., 447 F. Supp. 203, 212 (D. Mass. 1978); Stern v. American Bankshares Corp., 429 F.Supp. 818, 823 (E.D. Wis. 1977); Moerman v. Zipco, Inc., 302 F.Supp. 439, 447 (E.D. N.Y. 1969), *aff'd,* 422 F.2d 871 (2d Cir. 1970); Hecht v. Harris, Upham & Co., 283 F. Supp. 417, 438 (N.D. Cal. 1968), *modified in part on other grounds,* 430 F.2d 1202 (9th Cir. 1970); Lorenz v. Watson, 258 F. Supp. 724, 732 (E.D. Pa. 1966).

The Second and Third circuits, while apparently recognizing that good faith and non-inducement is an affirmative defense to be proven by the controlling person, have held that before the burden of proving good faith shifts to the controlling person, the plaintiff must prove not only that the requisite control existed, but also that the controlling person "culpably participated" in the activities which gave rise to a violation of the securities laws. Rochez Brothers, Inc. v. Rhoades, 527 F.2d 880, 889-91 (3d Cir. 1975);[2] Gordon v. Burr, 506 F.2d 1080, 1085-86 (2d Cir. 1974).[3] The Ninth Circuit, without deciding whether the plaintiff must prove culpability, agrees with the Second and Third Circuits to the extent that the plaintiff's prima facie case includes at least the burden of proving that the con-

trolling person *participated* in the activities which are claimed to violate the securities laws. Christoffel v. E.F. Hutton & Co., 588 F.2d 665, 668-69 (9th Cir. 1978).[4]

The Fifth Circuit has clearly rejected the position that the plaintiff must prove a controlling perons's participation, culpable or otherwise, in the wrongful activity. In *G.A. Thompson & Co., supra,* 636 F.2d at 957-58, the court quoted a regulatory definition of "control" at 17 C.F.R. § 230.405(f),[5] and stated:

> Neither this definition nor the statute [§ 20(a)] appears to require participation in the wrongful transaction.... Lack of participation and good faith constitute an affirmative defense for the controlling person. It is important to separate control from the good faith defense since the burden of proof with respect to the latter is on the defendant, while the burden of establishing control is on the plaintiff.

(Citations and footnotes omitted.) *Accord, Leff, supra,* 540 F.Supp. at 867 ("control need not be based...on active participation in the alleged wrongful act"); *Stern, supra,* 429 F.Supp. at 824; Holloway v. Howerdd, 377 F.Supp. 754, 761 (M.D. Tenn. 1973), *modified in part on other grounds,* 536 F.2d 690 (6th Cir. 1976); Harriman v. E.I. Dupont de Nemours and Co., 372 F.Supp. 101, 105 (D. Del. 1974).

The only Eighth Circuit cases which deal with controlling person liability under § 20(a), Myzel v. Fields, 386 F.2d 718, 737-39 (8th Cir. 1967), *cert. denied,* 390 U.S. 951 (1968), *disapproved on other grounds,* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 n. 12 (1976), and Klapmeier v. Telecheck International, Inc., 482 F.2d 247, 256-57 (8th Cir. 1973), do not specifically address this question. However, neither would appear to support the proposition that the plaintiff must prove either culpability or participation in the wrongful transaction.

This Court concludes that a plaintiff's prima facie case under § 20(a) does not include proof of the controlling person's culpability. Culpability and good faith are two sides of the same issue, and the cases unanimously hold that the burden of proving good faith is on the defendant. To require the plaintiff also to prove culpability would amount to giving both parties the burden of proof on the same issue.

The same may be true of participation and non-inducement, the latter being an essential part of the defendant's statutory defense. *See Harriman, supra,* 372 F.Supp. at 105 ("Under Section 20(a) the participation of a controlling person in the transaction of which plaintiffs complain is not relevant to liability except insofar as the defendant may demonstrate, by way of defense, that he did not 'directly or indirectly induce' that transaction."). In any event, the weight of authority is to the effect that the plaintiff need not prove participation in the activity which gives rise to liability, and the Court accepts that position as the law.

Having determined what the plaintiff need *not* prove, the Court now turns to what the plaintiff *must* prove to establish a prima facie case of control liability.

First, of course, the plaintiff must prove a primary violation of the federal securities laws.[6] *Briggs, supra,* 529 F.Supp. at 1170. Second, the plaintiff must prove that the defendant was a person who directly or indirectly controlled the primary violator at the time of the alleged violation. *Ibid.;* 5 A. Jacobs, *The Impact of Rule 10b-5* § 40.04, at 2-134 and n. 18.01 (1980) ("Whatever the appropriate test [for controlling person liability], it is applied as of the time of the ... [securities law] violation"). The scope of this "control" element requires further delineation.

In enacting § 20(a), Congress expressly declined to define "control", wishing to keep the concept flexible:

> [W]hen reference is made to "control," the term is intended to include actual control as well as what has been called legally enforceable control. ... It was thought undesirable to attempt to define the term. It would be difficult if not impossible to enumerate or to anticipate the many ways in which actual control may be exerted.

H.R. Rep. No. 1383, 73d Cong., 2d Sess. 26 (1934). Case law, however, has given some helpful content to the concept of "control".

An appropriate starting point for discussion is the following frequently quoted passage from *Myzel, supra,* 386 F.2d at 738:

> The statute [§ 20(a)] is remedial and is to be construed liberally. It has been interpreted as requiring only some indirect means of discipline or influence short of actual direction to hold a "controlling person" liable.

Other courts have also stressed the broad reach and the liberal construction to be accorded § 20(a). *E.g.,* SEC v. First Securities Co. of Chicago, *supra,* 463 F.2d at 987; Carr v. New York Stock Exchange, Inc., 414 F. Supp. 1292, 1302 (N.D. Cal. 1976).

"Control" under § 20(a) thus encompasses not only traditional agency relationships, such as employer-employee, but also any other relationship in which there exists the requisite power to influence or control. *E.g.,* Fey v. Walston & Co., 493 F.2d 1036, 1052 (7th Cir. 1974); *Harriman, supra,* 372 F. Supp. at 104. Several cases and commentators have recognized the possibility that a lender could become a "controlling person" with respect to a borrower. *See* In re Falstaff Brewing Corp. Antitrust Litigation, 441 F. Supp. 62, 68 (E.D. Mo. 1977) (§ 20(a) "was probably intended to apply to relationships like that of a broker and a brokerage company or a corporation and its controlling shareholder. However, by its terms it may apply to an entity, such as a lender, that assumes a controlling status.');

D. Lehr, "Some Securities Law Issues in Lending on Pledged Stock," 38 Bus. Lwyr. 91, 100 (1982) (hereinafter, "Lehr"); A. Sommer, Jr., "Who's 'In Control'?—S.E.C.," 21 Bus. Lwyr. 559, 564, 566, 571 (1966) (hereinafter, "Sommer"). However, the Court is aware of no case in which such liability has actually been imposed on a lender. *Accord,* Lehr, *supra,* at 101. *See, e.g.,* Fuls v. Shastina Properties, Inc., 448 F. Supp. 983, 989-90 (N.D. Cal. 1978) (granting lender's motion for summary judgment on controlling person count); Ferland v. Orange Groves of Florida, Inc., 377 F. Supp. 690, 707 (M.D. Fla. 1974) (memorandum opinion following trial to court, finding lender not liable as controlling person).

In discussing the meaning of "control" under § 20(a), the cases have made an important distinction between the *power* to control the activities of the primary violator and the actual exercise of such power, holding that the mere possession of power to control is sufficient. *Rochez Brothers, Inc., supra,* 527 F. 2d at 890-91 ("courts have given heavy consideration to the power or potential power to influence or control the activities of a person, as opposed to the actual exercise thereof"); *Savino, supra,* 507 F. Supp. at 1242-43; *Harriman, supra,* 372 F. Supp. at 105 (citing *Myzel, supra*); *Sommer, supra,* at 564-65.

A further distinction has been made in certain cases between control over the operations of a corporation in general and control over the specific corporate activity which gives rise to the primary violation. It has been held that a plaintiff seeking to hold a director liable as a controlling person of a corporation must first prove that the defendant actually participated in (i.e., *exercised* control) over the operations of the corporation in general; then he must prove that the defendant possed the power to control the specific transaction or activity upon which the primary violation is predicated, but he need not prove that this latter power was exercised. *Stern, supra,* 429 F. Supp. at 823-24; *Holloway, supra,* 377 F. Supp. at 761. *See* Note, "Liability of Corporate Directors as 'Controlling Persons'

Under Section 20(a) of the Securities Exchange Act," 28 Drake L. Rev. 437, 445 (1978-79) (formulation in *Stern* provides "good theoretical framework" for determining control).

Although both *Stern* and *Holloway* involved the liability of corporate directors with respect to a violation perpetrated by the corporation, the Court concludes that the same test should be applied to lenders. A lender should not be held to be a controlling person on lesser proof than that required in the case of a corporate director. Moreover, sound policy reasons support the application of the *Stern* test to lenders. A corporation's primary lender almost always possesses a measure of influence over the corporation, and this influence or power normally increases if the corporation becomes delinquent on its loan payments, due to the lender's ability to threaten declaration of default and acceleration of the loan. Most commercial loan agreements also give the lender the right to exercise certain powers over the borrower corporation in the event of default or upon the occurrence of other specified events. If the mere *possession* of such power and influence over a borrower were enough to impose on the lender the burden of proving its own good faith and non-inducement in the event of a securities law violation by the borrower, the heightened potential for liability could deter lenders from making loans to corporations involved in securities transactions. The mere making of such loans would impose on lenders an onerous duty of supervision over their borrowers' activities relating to securities. The imposition of such a duty is not reasonable unless and until the lender *exercises* its power by becoming involved in the *general operations* of the corporate borrower. For these reasons, the Court adopts the formulation set forth above as a proper statement of the law normally to be applied when control liability is sought to be imposed on the basis of a defendant's status as a lender.

It may be that a different rule would apply when the lender has obtained the right to vote a controlling block of stock in the borrower corporation as a result of a pledge of such stock as

collateral for a loan. *See Sommer, supra,* at 571. The uncontroverted evidence in the case at bar is that BTC, as a result of the MIL stock transaction, obtained the right to vote only about 17 or 18% of the outstanding voting stock of IEI. The following is therefore pertinent:

> [W]hile unencumbered ownership of more than fifty percent of the outstanding voting power of a corporation will usually constitute control even though unexercised simply because the power to control is there, ownership of substantially less than 50% of the stock may be indicative of control *only if the power inherent in the voting power has in some fashion been manifested through the exercise of control,* usually through the election of a favorably inclined majority of the board of directors.

Id. at 570 (emphasis added). Because BTC had the right to vote substantially less than 50% of IEI's stock, the existence of such voting rights in this case does not call for application of a rule different from that set forth in *Stern, supra.*

The Court also takes note of the following comment from *Falstaff, supra:*

> The allegation that the lender defendants controlled the daily affairs of Falstaff, although possibly difficult to prove, is surely sufficient under § 20(a) [for purposes of ruling on a motion to dismiss]. The Court reaches this conclusion in spite of its doubts that the lenders' efforts to secure their loans through various commercially acceptable methods would make them controlling persons.

441 F. Supp. at 68 (emphasis added).[7] The Court reads this statement as suggesting that it may be inappropriate to consider lenders as controlling persons unless there is proof that they went beyond ordinary efforts to secure their loans and actually became involved in the day-to-day operation of the borrower. Such a conclusion would be consistent with the *Stern* formulation.

The Court must next examine the evidence in this case and determine whether plaintiffs have generated a fact question on the required threshhold showing that BTC participated in (i.e., *exercised* control over) the operations of IEI during the period when IEI, through IMF, was engaged in the sale of thrift certificates (from 1970 until May 1974). Much of the evidence cited by plaintiffs as indicative of control shows at most unexercised power to control. While such evidence is probably relevant to satisfying the second prong of the *Stern* test (power to control the wrongful activity or transaction), it is not relevant to the first prong now under consideration.

Uncontroverted discovery evidence discloses the following affirmative actins of BTC with respect to IEI: (1) As a lender of substantial sums to IEI, BTC required IEI to provide it with audited annual financial statements and various other periodic financial reports. (2) On several occasions, BTC consulted with IEI concerning certain IEI acquisitions, participated in negotiations and provided financing for such acquisitions. (3) On one (and only one) occasion during the time when thrift certificates were being sold, two officers of BTC attended an IEI board of directors' meeting along with representatives of two other creditors. The minutes of this March 25, 1974, meeting reveal no active participation by the BTC officers in the meeting, but rather suggest that BTC probably attended due to its interest, as IEI's primary lender, in the financing matters which were being discussed. (4) On one occasion, at IEI's request, BTC acted as escrow agent for the exchange of notes for thrift certificates when two holders of notes on which IEI had become liable accepted IEI's offer to exchange their notes for thrift certificates.

The Court concludes that the foregoing actions,[8] considered as a whole and viewed in the light most favorable to plaintiffs, are insufficient as a matter of law to support a finding that BTC became an active participant in the operations of IEI. In each case, BTC was only acting as an ordinary commercial banker and lender, rather than asserting control over the operation of

IEI. There is no evidence, with respect to any time prior to May 1974 (when the sale of thrift certificates ceased), that BTC actually *exercised* any powers it may have possessed to become involved in the day-to-day operations of IEI.

BTC's power to vote 17 or 18% of the voting stock of IEI was also unexercised. BTC never attended an annual shareholders' meeting, and it gave IEI's management an unlimited proxy to vote the shares at the 1972, 1973 and 1974 annual meetings.

Accordingly, the Court concludes that plaintiffs have not generated a fact question with respect to their threshold burden of proving that BTC exercised control over the operations IEI in general. It therefore becomes unnecessary to consider whether plaintiffs could generate a fact question on the issue of BTC's power to control the sale of thrift certificates, or whether BTC would prevail as a matter of law on the statutory defense of good faith and non-inducement. The Court finds that BTC is entitled to summary judgment on plaintiffs' controlling person claim under § 20(a) of the Securities Exchange Act.

b. Aiding and abetting liability.

With respect to their claim that BTC aided and abetted violations of § 10(b) and Rule 10b-5, plaintiffs have the burden of proving: "(1) the existence of a securities law violation by the primary party (as opposed to the aiding and abetting party); (2) 'knowledge' of the violation on the part of the aider and abettor; and (3) 'substantial assistanbce' by the aider and abettor in the achievement of the primary violation." Stokes v. Lokken, 644 F. 2d 779, 782-83 (8th Cir. 1981). If proof of any one of these elements is lacking, there can be no liability. *Id.* at 782. 784. Moreover, these elements—especially the second and third — must be considered in relation to one another rather than in isolation. *Id.* at 784. The Eighth Circuit has noted, for example, that "where there is a minimal showing of substantial assistance, a greater showing of scienter is required." *Ibid.*

(citing Woodward v. Metro Bank of Dallas, 522 F. 2d 84, 95 (5th Cir. 1975) ("scienter requirement scales upward when activity is more remote") and Edwards & Hanly v. Wells Fargo Securities Clearance Corp., 602 F. 2d 478, 484 (2d Cir. 1979), *cert. denied,* 444 U.S. 1045 (1980)).

In this case, plaintiffs allege that IEI and IMF committed primary violations of § 10(b) and Rule 10b-5 by knowingly withholding material facts from persons considering purchase or renewal of IMF thrift certificates and by making material misrepresentations to such persons through newspaper advertisements. As noted in footnote 6, *supra,* BTC does not concede the existence of a primary violation, but it does concede for purposes of this motion that plaintiffs have generated a fact question on this element of proof. The Court will therefore assume for present purposes that IEI and IMF committed violations as alleged by plaintiffs.

Because the scienter or knowledge requirement varies with the amount of substantial assistance shown by the evidence, the Court turns next to the substantial assistance element. At pages 24-25 of their brief, plaintiffs cite the following affirmative actins of BTC as proof of substantial assistance. First, BTC demanded and received security for loans made to IEI and some of its subsidiaries. Also, when these borrowers became delinquent on their loans, BTC made numerous accommodations to keep the companies alive, often demanding and receiving additional collateral for doing so. In addition, although not mentioned in this portion of plaintiffs' brief, the Court again notes the one occasion on which, at IEI's request, BTC acted as escrow agent for the exchange of notes for thrift certificates when two noteholders accepted IEI's offer to make such an exchange.

The only other evidence of substantial assistance cited by plaintiffs consists of inaction: the fact that BTC did not act to halt the thrift certificate program or make disclosures to purchasers or renewers of thrift certificates.

The substantial assistance element of aiding and abetting has been construed as a causation concept. *Edwards & Hanly, supra,* 602 F. 2d at 484. *See also,* Landy v. FDIC, 486 F. 2d 139, 163-64 (3d Cir. 1973), *cert. denied,* 416 U.S. 960 (1974); In re Investors Funding Corp. of New York Securities Litigation, 523 F. Supp. 533, 542 (S.D. N.Y. 1980); Mendelsohn v. Capital Underwriters, Inc., 490 F. Supp. 1069, 1083-84 (N.D. Cal. 1979). In this regard, a showing of "but for" causation is not sufficient, and courts have required a proximate causal connection. *Edwards & Hanly, supra,* 602 F.2d at 484; *In re Investors, supra,* 523 F. Supp. at 542. As stated by one court, "a plaintiff must make some factual showing that the assistance provided by the alleged aider and abettor was a substantial factor in bringing about the violation." *Mendelsohn, supra,* 490 F. Supp. at 1084. In other words, the material misrepresentations and omissions of IEI/IMF in connection with sales and renewals of thrift certificates (hereinafter referred to as "the fraud") must have been a "direct or reasonably foreseeable consequence" of BTC's conduct. *In re Investors, supra,* 523 F. Supp. at 542.

The Court now examines the affirmative acts of BTC in light of the foregoing principles. BTC's demand for collateral when making loans or accommodations on loans to IEI and some of its subsidiaries is an ordinary banking practice which has no discernable causal connection with the IEI/IMF fraud. That practice may have had an effect on the amount of damages incurred by plaintiffs as a *result* of the fraud, but that is not the issue here. The issue is causation of the fraud itself.

BTC's efforts to keep the borrowing companies alive by making accommodations when delinquencies occurred may be sufficient to show "but for" causation,[9] but it cannot reasonably be said that the IEI/IMF fraud was a direct or reasonably foreseeable consequence of those efforts. Moreover, in *Landy, supra,* 486 F. 2d at 163, the court rejected the notion that "substantial assistance" could be equated "with a business transaction . . . which foreseeably permits one of the parties to it

. . .to independently engage in illegal action as to other parties". Thus, even if IEI/IMF's continued fraud *could* be considered a foreseeable consequence of BTC's efforts to keep IEI alive, those efforts would not constitute substantial assistance in the view of the *Landy* court.

BTC's only involvement with IMF thrift certificates was in its role as an escrow agent on one occasion, referred to earlier. This minor involvement was clearly tangential and ministerial and could not, as a matter of law, constitute substantial assistance to the fraud.

All that remains, then, is evidence of BTC's inaction. The question of whether, or to what extent, silence and inaction can fulfill the substantial assitance requirement apparently has not been addressed by the Eighth Circuit. It is a troublesome question upon which other courts have reached a variety of conclusions. *See, e.g., Woodward, supra,* 522 F. 2d at 96-97, and cases cited therein.

Some courts have held that silence and inaction cannot be a basis for aiding and abetting liability in the absence of an independent duty to disclose, i.e., a duty owed by the aider/abettor to the plaintiff either by statute or by virtue of common law. *Stern, supra,* 429 F. Supp. at 825-26; *see also Mendelsohn, supra,* 490 F. Supp. at 1086-87. In this case, it is clear that no such independent statutory or common law duty was owed by BTC to purchasers of IMF thrift certificates. This was true even in the one instance where BTC had some involvement in a thrift certificate transaction as an escrow agent. *See* Affiliated Ute Citizens v. United States, 406 U.S. 128, 151-52 (1972).

The Second Circuit, in IIT v. Cornfeld, 619 F. 2d 909, 927 (2d Cir. 1980), has likewise adopted the rule that inaction can create aider and abettor liability only when there is a violation of an independent duty to act, but it recognizes one exception. Under that exception, inaction can support liability in the absence of an independent duty if: (1) there is "clear evidence" of the re-

quired degree of scienter (the second element of aiding and abetting), and (2) there is "a conscious and specific motivation for not acting on the part of an entity with a direct involvement in the transaction." *Ibid.* This exception is inapplicable here even without regard to scienter and motivation, because there is no evidence that BTC had any direct involvement in the sale of thrift certificates.

Still another variation of the rule has been adopted by the Fifth Circuit in *Woodward, supra,* 522 F. 2d at 97: "When it is impossible to find any duty of disclosure, an alleged aider-abettor should be found liable [on the basis of silence and inaction] only if scienter of the high 'conscious intent' variety can be proved." The same rule, stated somewhat differently, is followed in the Third Circuit. *See* Monsen v. Consolidated Dressed Beef Co., 579 F.2d 793, 800 (3d Cir.), *cert. denied,* 439 U.S. 930 (1978) (inaction may provide for liability only where plaintiff demonstrates that aider-abettor "*consciously* intended to assist in the perpetration" of a securities law violation (emphasis in original)). Under the *Woodward-Monsen* test an evaluation of the evidence of scienter would become necessary in this case, although under the tests discussed in the twol preceding paragraphs, BTC would be entitled to summary judgment on the aiding-abetting claim without consideration of scienter. Since it is unclear which test the Eighth Circuit would adopt, the Court will assume the *Woodward-Monsen* test is applicable and will therefore proceed to the scienter element.

In discussing the scienter requirement for primary liability under § 10(b) and Rule 10b-5, the Supreme Court in *Hochfelder, supra,* 425 U.S. at 194 n. 12, made the following statement:

> In this opinion the term "scienter" refers to a mental state embracing intent to deceive, manipulative, or defraud. In certain areas of the law recklessness is considered to be a form of intentional conduct for purposes of

> imposing liability for some act. *We need not address here the question whether, in some circumstances, reckless behavior is sufficient for civil liability under* § **10(b) and Rule 10b-5.**

(Emphasis added.) In the context of aiding and abetting liability, the question of whether a reckless failure to discover the primary violation, as opposed to actual knowledge of such violation, is sufficient to satisfy the knowledge or scienter requirement also remains open in the Eighth Circuit. *Stokes, supra,* 644 F.2d at 783. There are several reasons why the Court need not decide in this case whether a reckless failure to discover the primary violation would be sufficient. First, plaintiffs state in their brief: "*Plaintiffs fo not allege BTC violated any duty to investigate or discover fraud,* but instead ... allege that BTC in fact knew, or had to have known, of the securities law violations (misrepresentations and nondisclosures) committed by IEI and IMF." (Emphasis added.) Second, even if plaintiffs had made no such statement, the *Woodward-Monsen* test being applied under the present circumstances requires proof of high conscious intent, and recklessness clearly falls short of that standard.

What plaintiffs must prove in this case, then, is that BTC had actual knowledge of the thrift certificate fraud and a high conscious intent to assist in the pertetration of that fraud by means of its silence and inaction. The Court will focus on the question of actual knowledge, because without such knowledge BTC could not have had the high *conscious* intent required by the *Woodward-Monsen* test.

As is often necessary with such issues, plaintiffs rely on circumstantial evidence and inferences for proof of BTC's knowledge and intent. The standards for drawing inferences on a motion for summary judgment were recently summarized by the Eighth Circuit in Impro Products, Inc. v. Herrick, 715 F.2d 1267 (8th Cir. 1983). Although *Impro* was a conspiracy case in

which inferences were relied upon for proof of an agreement, this Court is of the opinion that the same standards apply where, as here, inferences are relied upon for proof of actual knowledge of another party's fraud. The standards stated in *Impro,* as modified solely with reference to the issue of knowledge, are as follows. First, plaintiffs are not required to directly prove the fact of BTC's actual knowledge; evidence from which such knowledge could be inferred is sufficient. *Impro,* 715 F.2d at 1272. However, to avoid summary judgment, "the facts and circumstances relied upon must attain the dignity of substantial evidence and not be such as merely to create a suspicion." *Ibid.* (quoting Admiral Theatre Corp. v. Douglas Theatre Co., 585 F.2d 877, 884 (8th Cir. 1978)). In other words, the circumstances shown must lead to the conclusion with reasonable certainty. *Id.* at 1279. Furthermore, an inference with a jury is entitled to draw may not be based upon *other* inferences but must be based on proven facts. *Id.* at 1272.

With the foregoing principles in mind, the Court will review the evidence in this record relating to the question of whether BTC had actual knowledge of IEI/IMF's fraud. Deposition testimony by BTC officials indicates that BTC had a general knowledge of what thrift certificates were, as such certificates were being sold in Iowa by a number of companies at rates of interest higher than those offered by banks. Beyond such general knowledge, testimony and affidavits indicate that BTC knew little or nothing about IMF's particular thrift certificate program aside from the fact that the thrift certificate program aside from the fact that the thrift certificates appeared as a liability on IEI's consolidated balance sheets which were furnished periodically to BTC. Uncontroverted testimony and affidavits also show that no one from IEI or IMF ever discussed the IMF thrift certificates with any BTC official until December 1973 and early 1974, when the new Iowa law requiring registration of the certificates was about to take effect. These discussions took place shortly before the sale of thrift certificates ceased in May 1974.

Finally, and of primary importance, BTC officials testified and stated in their affidavits that they had no knowledge as to what information was being disclosed or not disclosed to potential thrift certificate purchasers.[10]

Despite BTC officials' sworn denials of knowledge of the fraud, plaintiffs assert that the record contains evidence which indicates BTC "must have known" of the fraud.[11] Plaintiffs note that the IEI balance sheets furnished to BTC had knowledge of the increasingly poor financial condition of IEI and IMF during this time period. Plaintiffs further cite evidence that BTC president Robert J. Sterling knew there was no effective regulation of the sale of thrift certificates in Iowa at the time in question. "Knowing all of this," plaintiffs argue, "BTC *had* to know that the only way IMF and IEI could be successfully selling its Thrift Certificates was without disclosing its true financial condition to purchasers. At least, no one could reasonably deny that a jury could reasonably so find."

The Court cannot agree. The fact that BTC possessed the foregoing information does not support an inference that it knew a full and proper disclosure was not being made to prospective purchasers of thrift certificates. The information might have caused BTC to speculate as to the reason for the increased sales and to suspect that IMF and IEI were not conducting the thrift certificate sales properly. BTC might even have been negligent in failing to obtain more information about the sales methods being used. However, as plaintiffs concede, liability as an aider and abettor is based on knowledge, not on the negligence standard of "should have known".

There are several reasons why the Court does not believe that a trier of fact could infer from the foregoing evidence that BTC had to know that the only way the thrift certificates could be so successfully marketed was by failing to disclose the companies' true financial condition to prospective purchasers. First, the Court believes that such an inference would depend not only on

evidentiary facts, but also on an assumption that if disclosure of the companies' financial condition had been made, thrift certificate sales would not have been as successful as they were. Only if this underlying assumption is true does the conclusion reached by plaintiffs follow with any reasonable degree of certainty from the facts in evidence. *See Impro, supra,* 715 F.2d at 1279.

In this regard, the Court notes that although IMF had a negative net worth by September 30, 1972, it was IEI which guaranteed the thrift certificates. Thus, information about the overall financial condition of IEI probably would have been of most concern to potential thrift certificate purchasers. Although IEI had a net operating loss beginning in fiscal 1972, IEI's consolidated balance sheets (which included IMF and other subsidiaries of IEI) showed a net worth of $975,000 at the end of fiscal 1972 and $500,000 at the end of fiscal 1973. This meant that there should have been enough to fully pay all creditors, including thrift certificate holders, and still leave the above-stated amounts for distribution to shareholders. Thus, in spite of the companies' financial difficulties, the situation regarding protection of thrift certificate purchasers did not appear so grave as to necessarily deter would-be purchasers to whom disclosure was made. In addition, an aggressive sales and advertising campaign promoting the higher interest rates offered on the thrift certificates could have attracted investors. It is well known in the financial world that many investors will assume obvious risks as a trade-off for a higher rate of return.

It is clear from the foregoing that plaintiffs' underlying assumption is questionable. Accordingly, it would be highly speculative to infer that BTC would have made that same assumption. If permisible inferences cannot depend on other inferences, *Impro, supra,* 715 F.2d at 1272, they clearly cannot depend on speculative or questionable assumptions.

Even if the underlying assumption were less questionable, there would be another significant problem with plaintiffs' sug-

gested inference. Despite the "must have *known*" language used by plaintiffs, the strongest conclusion that could actually be reached by use of plaintiffs' inference is that BTC must have *assumed* or strongly suspected that full disclosure was not being made to thrift certificate purchasers. An inference that a party made an assumption or had a strong suspicion does not rise to the level of an inference that the party had actual knowledge; thus, it is insufficient to prove the high conscious intent necessary under the *Woodward-Monsen* test.

Finally, the Court notes the similarity of plaintiffs' suggested inference to one discussed in *Impro, supra.* In that case, when a former official of the plaintiff corporation was asked to explain the facts on which he believed that one of the corporate defendants was aware of the allegedly illegal activities of a university professor who was doing some consulting work for the defendant company, the plaintiff's witness stated:

> They must have been aware of it or else they wouldn't have paid him. It's obvious to me. ... They must know what their people are doing or else they couldn't stay in business. Now that's just a fact, that they're an efficient company and have competent personnel, so when they hire someone and pay them a considerable amount of money, they must know what he's doing.

Impro, supra, 715 F.2d at 1278 n. 13. The inference that the corporate defendant "must have known" for the reasons stated by the witness was rejected by the Eighth Circuit as insufficient to controvert the company's sworn denials of knowledge or to generate a fact question on that issue.

In conclusion, the Court holds that BTC is entitled to summary judgment on plaintiffs' aiding and abetting claim, either because the uncontroverted evidence of BTC's role in relation to the primary fraud is legally insufficient to constitute "substantial assistance" under the tests set forth in *Stern* and *Cornfeld, supra,* or alternatively, if the *Woodward-Monsen* test

is applied, because the undisputed facts do not support a reasonable inference that BTC had actual knowledge of the primary fraud and a high conscious intent to assist in its perpetration.

C. **Conspiracy liability.**

Little need be said about plaintiffs' conspiracy claim. In their own brief, plaintiffs quote the following correct statement of law from Staffin v. Greenberg, 509 F. Supp. 825, 834 (E.D. Pa. 1981), *aff'd,* 672 F.2d 1196 (3d Cir. 1982): "[A]ll courts agree that knowledge of the wrongful act is an indispensible [sic] element of a conspiracy charge under section 10(b) and Rule 10b-5." As the Court has explained in conjunction with the aiding and abetting claim, the undisputed facts in this case do not support a reasonable inference that BTC had actual knowledge of the IEI/IMF fraud. BTC is therefore entitled to summary judgment on the conspiracy claim.

D. **Pendent state law claim.**

The only remaining claims against BTC are the pendent state law claims of Counts II and III of the amended complaint. When all federal claims against a party are disposed of before trial, the normal practice is to dismiss pendent claims without prejudice. *Stokes, supra,* 644 F.2d at 785. Plaintiffs' claims against BTC in Counts II and III will therefore be dismissed without prejudice.

V. **Reassertion of BTC's motion to dismiss.**

In making its motion for summary judgment, BTC reasserted its prior motion to dismiss plaintiffs' amended complaint for failure to state a claim upon which relief can be granted. In light of the foregoing disposition of plaintiffs' claims against BTC, it is unnecessary for the Court to consider BTC's reasserted motion to dismiss.

IT IS THEREFORE ORDERED that the motion for summary judgment filed by defendant Bankers Trust Company be and it hereby is granted as to all claims in Count I of plaintiffs' amended and substituted complaint.

IT IS FURTHER ORDERED that plaintiffs' pendent state law claims against defendant Bankers Trust Company, contained in Counts II and III of the amended and substituted complaint, be and they hereby are dismissed without prejudice.

IT IS FURTHER ORDERED that the reasserted motion to dismiss of Bankers Trust Company will not be considered, as it is moot.

IT IS FURTHER ORDERED that, because there is no just reason for delay, the Clerk shall enter final judgment pursuant to Fed. R. Civ. P. 54(b) in favor of defendant Bankers Trust Company and against plaintiffs on all claims in Count I of plaintiffs' amended and substituted complaint.

Signed this 9th day of January, 1984.

/s/ W. C. Stuart, Chief Judge
Southern District of Iowa.

Footnotes

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[1] The Court notes that the question of burden of proof was not before it in *Briggs*. Rather, the issue was whether joinder of the primary violator—as well as proof of his acts or omissions—was necessary in an action under § 20(a). 529 F.Supp. at 1170-71.

[2] The position of the Third Circuit has been made somewhat unclear by the decision in Gould v. American-Hawaiian Steamship Co., 535 F.2d 761, 779 (3d Cir. 1976), where the Court cited *Rochez* with approval and yet appeared to treat culpable participation as something to be negated by the controlling persons in proving their defense.

[3] The Second Circuit arguably abandoned this rule in *Marbury Management, Inc., supra,* when it stated that "where the erring salesman completes the transactions through the employing brokerage house and the brokerage house receives a commission on the transactions, the burden of proving good faith is shifted to the brokerage house. ..." 629 F.2d at 716. Judge Ward of the Eastern District of New York has read *Marbury Management* as holding that the plaintiff's prima facie burden under § 20(a) is discharged when the plaintiff presents proof of control by status, i.e., proof that the defendant had a means of controlling the principal's conduct. *Savino, supra,* 507 F. Supp. at 1243. *But see* O'Connor & Assoc. v. Dean Witter Reynolds, Inc., 529 F. Supp. 1179, 1194-95 (S.D. N.Y. 1981) (Judge Lasker applying "culpable participation" requirement in dismissing plaintiff's complaint for failure to allege facts showing knowledge, reckless disregard or participation by the controlling person in the alleged fraud).

[4] However, in Kersh v. General Council of the Assemblies of God, 535 F. Supp. 494, 497-98 (N.D. Cal. 1982), Judge Henderson ruled that the "participation" requirement of *Christoffel* applies only when no independent duty to supervise the controlled person exists. When the controlling person does have a duty to supervise the controlled person, the plaintiff need only allege and prove reckless nonfeasance. *Ibid.*

[5]. The regulation reads:

> The term "control" ... means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through ownership of voting securities, by contract, or otherwise.

This regulation defines "control" for purposes of reports issuers are required to file under the Securities Exchange Act. Although it is not clear that this definition applies to § 20(a), some courts have referred to it in discussing controlling person liability. *See* 5 A. Jacobs, *The Impact of Rule 10b-5* § 40.04, at 2-131 and n. 7 (1980), and cases cited therein.

[6] Although BTC does not concede the existence of a primary violation, it does concede, for purposes of this motion only, that plaintiffs have generated a fact question on this element of proof.

[7] The plaintiff in *Falstaff* had alleged on information and belief that the lenders became involved in the day-to-day operation of Falstaff. He had further alleged that the lenders threatened to declare a default and accelerate payment on their loans unless Falstaff would:)1)

replace acting directors and officers; (2) implement certain policies; (3) revise its debt structure; (4) obtain an equity investor; (5) give additional security; and (6) obtain lender approval before acquiring or selling capital assets. 441 F. supp. at 65.

[9] There is a great deal of other evidence in the record concerning actions taken by BTC in its role as lender to IEI. This evidence is not listed above because it is even farther removed from any indication of participation in the general operations of IEI than is the evidence cited.

[9] I.e., but for the continued existence of IEI, the thrift certificate program and accompanying fraud could not have continued.

[10] With regard to the newspaper advertisements in which misrepresentations allegedly appeared, the affidavits and testimony indicate that BTC officials do not recall seeing the IMF thrift certificate ads, but that even if they had seen the ads, they would not have known whether or not the statements made therein were correct because of their lack of knowledge about the operations of IMF.

[11] The Court does not equate the phrase "must have known" with "should have known". Plaintiffs apparently intend the phrase "must have known" to suggest an inference of actual knowledge, while "should have known" would encompass a negligent failure to discover.

Supreme Court, U.S.
FILED
OCT 31 1985
JOSEPH F. SPANIOL, JR.
CLERK

(3)

No. 85-555

In The
Supreme Court of the United States
October Term, 1985

BANKERS TRUST COMPANY,

Petitioner,

vs.

THELMA T. METGE, Executrix of the Estate of August Metge, and ELIZABETH G. SHEPARD, on behalf of themselves and on behalf of all others similarly situated,

Respondents.

On Petition for Writ of Certiorari to the United States Court of Appeals For the Eighth Circuit

BRIEF IN OPPOSITION

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QUESTION PRESENTED

SHOULD THIS COURT GRANT CERTIORARI WHEN THE DECISION OF THE COURT OF APPEALS IS NOT IN CONFLICT WITH DECISIONS OF OTHER COURTS OF APPEALS OR WITH PRIOR DECISIONS OF THIS COURT, IS INTERLOCUTORY AND AFFECTS ONLY THE PARTIES TO THIS ACTION, AND IS BASED UPON A FACT QUESTION IN THE CONTEXT OF APPROPRIATE SUMMARY JUDGMENT STANDARDS CORRECTLY APPLIED.

PARTIES TO THE PROCEEDINGS

Plaintiffs named in the caption in this case are representing themselves and a class of approximately 635 individuals similarly situated which has been certified by the District Court. The Appendix to Plaintiffs' Cross-Petition For Writ of Certiorari filed contemporaneously herewith contains a list of members of the Plaintiff class.

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Respondents.

On Petition for Writ of Certiorari to the United States Court of Appeals For the Eighth Circuit

BRIEF IN OPPOSITION

Respondents Thelma T. Metge, Executrix of the Estate of August Metge, and Elizabeth G. Shepard, on behalf of themselves and all others similarly situated ("Plaintiffs"), respectfully oppose the Petition for Writ of Certiorari to review the opinion and judgment of the United States Court of Appeals for the Eighth Circuit entered in the above-captioned case on May 15, 1985.

OPINIONS BELOW

The opinion of the Court of Appeals is reported at 762 F.2d 621 (8th Cir. 1985). The opinion of the District Court is reported at 577 F.Supp. 810 (S.D. Iowa 1984). Both opinions are reproduced in the Appendix to the Petition for Writ of Certiorari.

———o———

JURISDICTION

See Petition for Writ of Certiorari, at page 2.

———o———

PROVISIONS OF STATUTES AND RULES INVOLVED

See Petition for Writ of Certiorari, at pages 2-3.

———o———

STATEMENT OF THE CASE

Pursuant to Sup. Ct. R. 34.2, Respondents adopt the two paragraphs of the Petition entitled "Statement of the Case." The sole correction to be noted is that while Bankers Trust Company ("BTC") is a named defendant in this action, its officers and directors are not.

Statement of Facts

It is important to understand that this action involves complicated and voluminous facts. BTC's conduct can only be understood against the backdrop of its long-standing relationships with IEI, the primary violator, and predecessor borrowers. Because of the complexity of this case, as well as the necessity of proof by circumstantial

evidence and inference, it is essential to provide a more complete, detailed and accurate picture of the facts than is contained in BTC's petition. A concise summary of the voluminous record evidence is therefore provided.

A. IEI and IMF—Background and Primary Violation

Investors Equity, Inc. ("IEI") was an Iowa corporation formed in the early 1960's to buy and service real estate contracts on low-cost homes. In 1969, because of dwindling profits and a desire to move IEI to more "high-risk, high-return" ventures, IEI formed Investors Mortgage & Finance Co. ("IMF"), a thinly-capitalized subsidiary corporation, to raise venture capital for IEI by the public sale of unregistered, unsecured, one-year renewable, promissory note-type securities called "Thrift Certificates". Beginning in 1970 IEI also issued its "Thrift Certificate Guarantee Bonds" which "unconditionally guaranteed" the Thrift Certificates. Initially IEI traded real estate contracts to IMF in return for Thrift Certificate proceeds, but by 1970 IMF merely loaned the Thrift Certificate proceeds to IEI in return for IEI's unsecured promissory notes. (By its bankruptcy in 1974 IMF's assets were mostly worthless IEI notes.) During the next several years IEI had no problem selling Thrift Certificates or finding "high-risk" investments. By 1971 IEI owned two unsuccessful lake development projects and a "disaster" of a commercial office project, and by 1974, the year of IEI's bankruptcy, the outstanding balance of Thrift Certificates was $1,500,000. IEI's violations of the anti-fraud provisions of the Federal securities laws were conceded by BTC in this summary judgment proceeding. They include fraudulent misrepresentations (non-existent collateral and fictitious use of Thrift Certificate proceeds)

and numerous non-disclosures of material facts, *e.g.*, financial condition of IEI/IMF, the need for and use of Thrift Certificate proceeds and BTC's unusual "loan" activities.

B. Plaintiffs

Plaintiffs are 635 holders of worthless Thrift Certificates and Thrift Certificate Guarantee Bonds. Their aggregate investment is $1,500,000, and their average individual investment is under $3,000. They have received none of their principal and only a few dollars of their interest. They are primarily retired persons, farmers, teachers, artisans and trades people.

C. History of MIL

Mid-Iowa Lakes Corporation ("MIL") was an Iowa corporation formed in the mid-1960's to develop Lake Panorama, a recreational lake development project near Des Moines. BTC was its stock transfer agent and the escrow agent for an early stock offering. Times were always bad for MIL. Its lake project was ill-conceived; its management was poor; its losses were large and constant; its lawsuits were many; and it never had enough money to pay its bills or complete its amenities.

D. Woodland Debt—Origin of BTC's Losses

Woodland Corporation ("Woodland") was an Iowa corporation operating in Des Moines in the 1960's. BTC was its depository bank, primary lender and stock transfer agent. In 1967 BTC was in trouble on some large loans to several Des Moines drug companies. With encouragement and acquisition financing from BTC, Woodland purchased the drug companies and restructured and assumed their

BTC debt ("Woodland Operations Loans"). The drug companies did even worse under Woodland, and by 1968 Woodland was in trouble and the Woodland Operations Loans were in substantial default. In late 1968, despite its financial woes, Woodland decided to purchase a controlling block of stock in MIL ("MIL Stock") and to raise money therefor by the public sale of Woodland debentures and warrants. BTC, who was aware of MIL's many problems, refused to consent to the transaction until Woodland agreed that a large part of the debenture proceeds would be used to reduce the Woodland Operations Loans. BTC then advanced $180,000 of the purchase price of the MIL Stock, loaned acquisition money to several debenture purchasers and disseminated the warrants. In late 1969, with the drug companies folding and Woodland hopelessly insolvent, BTC demanded and received from Woodland the MIL Stock as additional collateral for the Woodland Operations Loans. In February of 1970, as BTC was repossessing the drug companies' inventories, BTC demanded and received from Woodland an irrevocable and unlimited proxy to vote the MIL Stock. A few days later Woodland dumped the drug companies in bankruptcy, but, on BTC's "advice", Woodland stayed out of bankruptcy itself to help BTC find a buyer for the MIL Stock. (Some Woodland directors were beholden to BTC on other loans.) BTC knew it was in a "bad situation" on the Woodland Operations Loans and that its "only chance" to avoid a huge loss was to sell the control block of MIL Stock for a large sum of money. BTC also knew that selling the MIL Stock would not be easy—very few companies were interested in lake projects, especially ones with MIL's problems.

E. Sale of MIL Stock and Transfer of Woodland Debt

During the next twelve months BTC did what it could to stabilize MIL while it searched for a buyer for the MIL Stock. MIL was in dire need of $1,500,000 to pay large debts and immediate operating expenses, but all it could find was a $950,000 mortgage loan from an Omaha bank. "Purely to keep everything afloat" and "to bail out" MIL, BTC approached the Omaha bank and got it to increase the loan to $1,450,000 in return for a $500,000 BTC participation. BTC also reshaped MIL's management. BTC's president wanted MIL to add some directors and create an executive committee and when MIL balked he appeared at its January 1971 board meeting, armed with the irrevocable proxy taken in 1970 "to assure good management" (*supra* at 5), and the changes were made.

By February of 1971 BTC had interested only two potential purchasers in the MIL Stock. One was MIL itself (actually, dissident directors), and the other was IEI. Both were willing to pay approximately $950,000 (the balance of the Woodland Operations Loans), and both needed BTC to finance most of the purchase price. Although IEI had absolutely no experience in lake development and could pay less cash down, BTC chose IEI for several obvious reasons. Firstly, BTC had a good history with IEI. It was IEI's depository bank and primary lender since 1961, and IEI's president had a close relationship with BTC's president. Also, in the late 1960's IEI, with acquisition "loans" from BTC, bought two other struggling companies and thereby bailed out BTC on several bad loans. Secondly, BTC was aware of MIL's critical need for additional financing. BTC thought that IEI, despite its own financial problems, had a better chance of getting a development loan (which could be used in part to repay

BTC) or having enough money to keep MIL going until a buyer of substance could be found. BTC was aware of IEI's success in raising money from the sale of Thrift Certificates). Thirdly, Woodland principals (who now claim that BTC tricked them into believing that they had some continuing liability on an expired 1970 option contract) were willing to guaranty a portion of an acquisition loan to IEI.

IEI and BTC closed the sale on March 31, 1971. IEI got a terrible deal, but BTC fared much better. The $950,000 of delinquent Woodland Operations Loans were wiped off BTC's books—"paid" on paper by the $950,000 purchase price of the MIL Stock. $130,000 of the purchase price was paid in cash, and the $820,000 balance was "current" (safe from immediate charge-off) and owed by a company "better off than [Woodland]". However, BTC knew it was not "out of the woods"—it still had a large potential loss, and its collateral (the MIL Stock) "wasn't worth a damn" unless Lake Panorama was developed "at a terrific profit"—but BTC sold the MIL Stock to IEI (and financed the sale with a "risky" loan "it wouldn't have [otherwise] made") hoping that IEI could keep MIL going and make some loan payments and sell or refinance MIL and pay BTC with the proceeds.

F. Purchase Terms and Documents

The purchase price of the MIL Stock was paid as follows: (1) $130,000 cash at closing, at least $100,000 of which was Thrift Certificate proceeds; (2) IEI's "Collateral Pledge Note" (Acquisition Note") for $575,000; and (3) 50,000 shares of IEI common stock ("IEI Stock") valued at $245,000.

The Acquisition Note called for quarterly payments and a balloon on September 1, 1972. It was secured by the

MIL Stock, and BTC knew that possession of the MIL Stock, plus stock powers endorsed in blank by IEI, gave BTC the power to transfer the MIL Stock to itself or a purchaser (without foreclosure) if IEI defaulted. BTC also received an "Irrevocable Proxy" ("MIL Proxy") to vote the MIL Stock whenever IEI was in default on the Acquisition Note (virtually all the time). BTC demanded the MIL Proxy because of its concern over the outcome of the sale of the MIL Stock to IEI. In the words of BTC's president, "It was a nice comfortable instrument to have". (He found this to be so in January of 1971 with a predecessor proxy. *Supra* at 6.) BTC knew that the MIL Proxy gave it the unilateral power to call meetings, remove and elect directors and officers, amend articles and by-laws and generally control the affairs of MIL. (Because MIL was IEI's principal asset—it dwarfed IEI—the MIL Proxy was as compelling to IEI as it was to MIL.) According to BTC's senior loan officer, the MIL Proxy was "unique" and not something used before or since by BTC. It was against his practice to take a proxy, because "exercising" one would amount to conducting a borrower's business.

The $245,000 of IEI Stock received by BTC was 17-18% of IEI's widely-held voting stock. The next largest stockholder owned 4%. BTC knew that the IEI Stock entitled it to receive dividends on the IEI Stock and IEI stockholder communications and to attend and call stockholder meetings. It also knew that "many corporations *are controlled by less than a 50% ownership.*" (BTC received dividends on the IEI Stock and stockholder communications and, in effect, voted the IEI Stock by giving its proxy on three occasions to "educated"[1] IEI manage-

[1] According to BTC's president, IEI's management knew what BTC's "wishes were on almost anything in relation to [IEI and MIL]" and they "knew what BTC expected".

ment.) BTC could have increased the Acquisition Note by another $245,000 and not violated the admitted axiom that banks not own stock in their borrowers. Instead, BTC purposefully hid its ownership of the IEI Stock by registering it in the name of Bell & Co., a partnership of senior BTC officers. The IEI Stock was subject to a "put" option which gave BTC the right to require IEI to purchase the IEI Stock from BTC for $245,000. BTC admits that "puts" are unusual in the banking business.

An agreement ("Purchase Agreement") dated March 18, 1971, set forth other terms of the sale. It provided for yearly audited financials for IEI and MIL, quarterly unaudited financials (to better "track the operations of the companies"), additional information as and when desired by BTC and access by BTC to IEI's and MIL's books and records. It prohibited IEI from paying dividends[2] or selling substantial assets without BTC's consent. The Purchase Agreement also empowered BTC to require IEI to do a public offering of IEI capital stock to raise funds to pay the Acquisition Note and repurchase the IEI Stock. BTC's senior loan officer admits that this provision was very unusual and not used before or since by BTC. He is surprised that any borrower would give its bank such a power.

G. Keeping "Afloat"—Thrift Certificates and BTC

MIL was no less a mistake for IEI than the drug companies were for Woodland. Lake Panorama was underdeveloped and oversold, and the potential profits were

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[2] BTC approved a small dividend distribution in early 1972 (receiving $1,000 itself), even though IEI just reported a FY 1971 loss. BTC booked the dividend it received as non-loan income.

gone. IEI could neither afford to sustain the project nor let it die. No one would lend development monies, and buyers were not to be found. To make matters worse, IEI's president simultaneously committed IEI to two other expensive and full-time projects. One was a lake development project in southern Missouri called "Arrowhead Resorts, Inc." ("ARI"), and the other was a commercial office project in Des Moines called "West Bank". The long and involved story of how IEI survived for 3-½ years after purchasing the MIL Stock is summarized in the following paragraphs. The reasons it survived are Thrift Certificate proceeds and the actions and indulgences of BTC.

With its cash committed to sustaining its projects, IEI missed the first and second quarterly installments due BTC on the Acquisition Note. It had promised BTC to make a payment with the first advance of an $800,000 *ARI* development loan, but the prospective Missouri lender required a credit reference and "take-out" financing. BTC stepped in and vouched for IEI's creditworthiness and committed a $200,000 take-out loan. As a result, BTC received $65,000 of the *ARI* loan.[3] (BTC's president admits the purpose and result of this maneuver, but BTC's senior loan officer states that he never questioned the source of a loan payment, "not when you get paid".)

In February of 1972 BTC reviewed and wrote up IEI's and MIL's FYE 9-30-71 financial statements. The numbers were bad, but not unexpected—BTC had received interim financials and verbal reports. ("They kept us apprised of what was happening. We never had any

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[3] BTC never funded the take-out loan, and the ARI lender lost its money when ARI went bankrupt.

surprises from IEI.") IEI lost $26,300, and its current assets-to-current liabilities and debt-to-net worth ratios were 0.231:1 and 8.7:1, respectively. According to BTC, these are the two most important ratios, and they were "poor". BTC's write-up discussed Thrift Certificates by name, character ("one-year term, renewable at the option of the holder") and cumulative balance ($392,100) and noted the 300% increase from FYE 9-30-70. During the balance of 1972 BTC received quarterly financial statements and voluminous other financial documents, *e.g.*, lot sales reports, cash flow projections, expense reports, schedules of receivables, payables and investments and minutes of MIL board meetings. BTC relied on these documents and frequent verbal reports for day-to-day lending decisions. BTC was especially interested in documents regarding cash flow and cash source, because they showed BTC how it was going to be paid. One such document was IEI's break-even "Cash Flow Projection—April 1, 1972, to September 30, 1972". The "cash-out" section projected timely payment of the Acquisition Note and the "put" based on "cash-in" projections of $15,000 per month of net Thrift Certificate sales. (Thrift Certificates were obviously necessary to IEI's cash flow and to BTC's chances of being paid.) BTC also received at least one of IEI's 1972 (August) Thrift Certificate recap sheets showing monthly sales, redemptions and cumulative balances.

In April of 1972 IEI owed payments on notes it assumed when it purchased a venture-capital company named "Triple Eye" in 1971. BTC was the former depository bank and stock transfer agent for Triple Eye and was the escrow agent hired to receive and remit the Triple Eye note payments. IEI asked the Triple Eye noteholders to

trade their notes for Thrift Certificates.[4] Some wrote to BTC and declined the offer, but two noteholders (both Plaintiffs herein) mailed their notes to BTC, and BTC sent back Thrift Certificates. BTC's president admits that this transaction was passed by him before consummation.

In May of 1972 IEI "demoted" its president (decreased his duties) on account of his alcoholism and poor performance. His long-time relationship with BTC's president was a reason he was not fired. BTC was aware of his problems and the dissention he was causing. It was informed of his demotion in advance, and approved.

By summer of 1972 it was obvious that IEI could not pay the Acquisition Note or perform the "put" on September 1. BTC chose renewal over litigation and liquidation. It knew its only chance of substantial recovery was for IEI and its subsidiaries to stay in business. BTC hosted a luncheon for the ex-Woodland people who had guarantied a portion of the Acquisition Note (*supra* at 7) and then sent them a confirming letter stating that the Acquisition Note would not be renewed without their signed consent and that additional collateral would be given to secure the Acquisition Note (the obligation they guarantied) as well as the "put". Testimony and documents show that BTC intended to renew with or without the guarantors' consent and that renewal papers were already drafted (and would be signed) to only benefit the "put" with the new collateral, *i.e.*, BTC lied to the guarantors to get their signatures.

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[4] BTC received copies of the solicitation letters which enclosed newspaper advertisements for Thrift Certificates and pandered high interest rates and IEI's "unconditional guarantee".

The Acquisition Note and the "put" were renewed on September 30, 1972, for two years. The amended Purchase Agreement ("Amended Purchase Agreement") required an immediate $30,000 cash payment and a new installment balloon note ("Renewal Note") for the balance of the Acquisition Note. The "put" price was increased to $300,000, and an 11% "service charge" was added.[5] Also, the "put" was secured with ARI's voting stock (with blank stock powers signed by IEI) and junior mortgages on IEI's home office building and the West Bank project. The Amended Purchase Agreement required *monthly* consolidat*ing* (versus quarterly consolidated) financial statements for IEI and MIL and *each of their subsidiaries* (including IMF). It also prohibited large IEI borrowings without BTC's consent, so BTC could veto future unwise investments and partake of the proceeds of third-party loans. The $30,000 cash payment was made in Thrift Certificate proceeds. In fact, on September 30 (a Saturday) BTC's senior loan officer was given a $30,000 IMF check payable to IEI, an IEI deposit slip to its BTC checking account and a $30,000 IEI check to BTC, and he banked them the following Monday. In conclusion, the renewal of the Acquisition Note and the "put" gave BTC $30,000 cash, some collateral for the "put" (placing BTC further ahead of other creditors), another opportunity to bring the former Woodland Operations Loans "current" on its books and some additional information and controls over IEI.

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[5] BTC's senior loan officer initially structured the Amended Purchase Agreement to replace the IEI Stock with a $300,000 secured loan, but BTC's president quashed the change. (BTC would have lost its stockholder powers, and IEI did not need $300,000 more debt on its balance sheet.)

BTC reviewed and wrote-up IEI's FYE 9-30-72 financial statements in March of 1973. IEI lost $323,100 (twelve times more than FYE 9-30-71), and its debt-to-net worth ratio jumped to a worse-than-"poor" 13.26:1. BTC's write-up noted that IEI was "under extreme debt pressure and company leverage for creditors [was] severely limited". BTC's senior loan officer said this meant that IEI's debt was not serviceable from earnings and additional financing or capital was needed to service debt. As for additional financing, BTC's write-up also noted that "Thrift Certificates, one-year renewable at option of the holder amount to $694,970 up from $392,100 in 1971". IEI's statement disclosed another "rather significant event . . . lending wise" in BTC's opinion, *i.e.*, IEI's auditors prepared its 1972 financials on a "going concern basis". BTC knew this to mean that the balance sheet numbers were only accurate if IEI could stay in business, save its assets from secured creditors, find needed financing, resolve threatening lawsuits and become profitable; otherwise, IEI had no net worth. (BTC had long ago realized that, notwithstanding its collateral, it would lose big if IEI/MIL folded.) MIL's and ARI's FYE 9-30-72 statements were equally bad. During 1973 BTC received the same voluminous interim documents and frequent verbal reports as before plus the newly required *monthly* consolidating financial statements ("trial balances"). The "trial balances" exposed large and increasing Thrift Certificates sales, IMF's portfolio of unsecured IEI notes and IMF's negative net worth since 9-30-72.

In April of 1973 IEI had to either unload the West Bank project or go down with it. It needed the help of BTC and its earlier-demoted president (the son-in-law of

a major West Bank creditor). BTC agreed to trade its then worthless West Bank mortgage (recently received to secure the "put") for a good $12,000 note receivable, and it consented to the "sale" of an IEI owned real estate service company to IEI's president (to buy him off). ($91,500 of Thrift Certificates were sold/renewed in April of 1973.)

By May of 1973 IEI was in default on the first and second quarterly payments on the Renewal Note, on the service charge on the "put" and on two older BTC loans. Fearing this $71,000 delinquency would close IEI's doors, BTC's president orchestrated an unusual transaction "to keep IEI in business". He required IEI to borrow $71,000 from BTC and use the loan proceeds to "pay" $71,000 to BTC. He also required MIL to issue a $71,000 note to IEI so IEI could pledge it on its "new" $71,000 loan from BTC. Finally, he required IEI to secure a previously unsecured operating loan with the MIL Stock. The $71,000 loan was a fiction and a "wash". In effect, BTC loaned $71,000 to itself to keep IEI going. It also turned delinquent loans into "current" loans and got more collateral to put itself further ahead of general creditors *e.g.*, Thrift Certificate holders. In BTC's words, it was "weathering the storm"; its collateral "wasn't worth a damn" if IEI and MIL closed their doors. ($52,000 of Thrift Certificates were sold/renewed in May of 1973.)

In August of 1973, shortly after missing the third quarterly Renewal Note and service charge payments, IEI had to sell its home office building. BTC approved the sale in return for the net sales proceeds. $50,000 was paid on the "put", and $23,965.46 was paid on the Renewal Note (which was not even secured by the building). IEI hid the

sale from Thrift Certificate holders/purchasers so as not to alarm them. ($367,000 of Thrift Certificates were sold/renewed in June, July and August of 1973.)

By November of 1973 the "energy crisis" had all but stopped MIL's and ARI's sales of lake lots. In the words of BTC's president, the recreational lot business "collapsed", and MIL "fell flat on its face". IEI also missed the fourth quarterly Renewal Note and service charge payments. On November 19 IEI's new president met with BTC's president and senior loan officer to review IEI's situation. Recent financials showed large delinquent obligations and a large cash deficit. A current Thrift Certificate recap sheet and "trial balance" exposed accelerated Thrift Certificate sales and a larger negative net worth for IMF. IEI's president was told to report back the next day with figures showing the "cash required by IEI and its subsidiaries to put all of the companies on a sound financial basis". On November 20 he reported that MIL and ARI each needed $2,500,000 and IEI needed $1,122,465. BTC was not surprised. It had always known about the critical need for (and absence of) large development loans. It had counted on receiving a large portion of any development loan. It had reviewed IEI's third-party loan applications, offered suggestions and even contacted potential lenders. ($313,500 of Thrift Certificates were sold/renewed in September, October and November of 1973.)

In late November, 1973, an Omaha lender refused MIL's urgent request to release monies from a reserve account securing factored real estate contracts. In early December BTC's president accompanied IEI's president to Omaha in search of a "solution to [MIL's] problems". They came back with monies from the reserve account, and MIL paid some pressing bills.

On December 31, 1973, BTC made a secured, $69,000 "emergency" loan to IEI to pay delinquent, existence-threatening real estate taxes. In BTC's words, "At this time everything [IEI] was doing was emergency". ($66,500 of Thrift Certificates were sold/renewed in December of 1973.)

In March of 1974 BTC's president helped IEI collect a note receivable by making written demand on the maker. He falsely stated that BTC owned the note. The resulting $13,000 payment was applied to the "put", even though BTC had not exercised "put".

BTC did everything it could in early 1974 to keep IEI and MIL going for another sales season without "exposing [itself] any greater", because it knew what would happen to its loans and collateral if they failed. "To keep [IEI and MIL] going" and to improve its position *vis-a-vis* other creditors, BTC orchestrated another unusual "loan" transaction. It required MIL to issue a $25,000 note to IEI and IEI to pledge the note to secure the unpaid balance of IEI's May 1973 $71,000 "loan" (*supra* at 15). It also required MIL to borrow $46,000 from BTC to pay IEI so IEI could use the money, plus $16,000 of other funds, to pay BTC and bring its loans "current". (The other funds turned out to be Thrift Certificate proceeds.) BTC also required IEI to pledge its stock in a plastics company to secure another old loan. "[BTC's] primary purpose was to try to keep both organizations afloat", so it could receive more money. It also got $16,000 cash and more collateral; $46,000 of IEI debt was transferred to MIL (who had a better financial statement); and the Woodland Operations Loans (now IEI and MIL obligations) were "current" once again. On March 25 BTC's president and senior loan officer attended IEI and MIL board meetings. After

reviewing financial statements[6] with directors and auditors, BTC's president demanded and received additional collateral—"as much as [BTC] could get"—including ARI notes and voting stock of another subsidiary. He also required MIL to borrow another $25,000 from BTC and pay it to IEI so IEI could pay the balance of the May 1973 $71,000 "loan". ($439,600 of Thrift Certificates were sold/renewed in January, February and March of 1974.)

In April of 1974 IEI defaulted on the sixth consecutive Renewal Note payment, and BTC reviewed and wrote-up IEI's FYE 9-30-73 "going-concern" financial statements. IEI had a record $400,000 loss, and the Thrift Certificate balance had doubled to $1,142,909. ($141,200 of Thrift Certificates were sold/renewed in April of 1974.)

On or about May 10, 1974, IEI's president met with BTC's president and senior loan officer to inform them of a change in the Iowa securities laws which prohibited the future sale and renewal of Thrift Certificates without registration.

In July of 1974 IEI was preparing to file bankruptcy for itself and its subsidiaries. On July 23 BTC's president, armed with the IEI Stock, the MIL Stock and the MIL Proxy, attended a joint IEI-MIL board meeting and vetoed a proposal to put MIL in bankruptcy. He thought it would destroy the value of the MIL Stock, BTC's collateral. IEI, IMF and ARI filed bankruptcy on August 22, 1974, but not MIL. On August 20 BTC used a dummy

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[6] The financials showed large losses, a big decline in IEI's "going-concern" (imaginary) net worth and a huge increase in Thrift Certificate sales—the Thrift Certificate balance went from $694,970 at FYE 9-30-72 to $1,142,909 at 9-30-73 to $1,443,745.87 on March 25, 1974.

corporation called "Aquarius, Inc." to "buy" the Renewal Note and collateral therefor (MIL Stock) and the "put" with a 100% acquisition "loan" from BTC. Aquarius was owned and staffed (on paper) by non-bank businessmen but was run by BTC's president as BTC's "alter ego". The debt of Woodland (and then of IEI) was "current" once again, and BTC was firmly in control of its new "borrower". (BTC admitted in depositions that it never used anything like Aquarius before.) BTC's president, wearing his Aquarius hat and waving the MIL Proxy, then set about to "effect [MIL] management by friendly persuasion". First he made it clear to MIL management that he could "rock the boat" (meaning "fire everybody, hire new people") if not satisfied with their performance. Then he told MIL's management that liquidation was not desirable and that "[MIL] should stay operational as [MIL] was the primary salvation in order for Aquarius, Ltd. [/BTC] to recover on [IEI's] debt". Then he returned to Omaha with MIL's president to see if the Omaha bank would put up some more money to salvage MIL, and, when the Omaha bank balked because of its distrust for MIL management, BTC conducted the firing of MIL's president and the addition of a new member to the MIL board. A few months later BTC gave up, and MIL sunk into bankruptcy.

H. BTC's Benefit and Knowledge

BTC did not really "lose over $650,000 . . . due to IEI's insolvency"[7] in 1974, as it insists in its petition; it

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[7] The District Court apparently understood that a $650,000 loss was "undisputed" by Plaintiffs. (Appendix to BTC's petition at A-14.) This is incorrect.

really lost $950,000 in 1970 due to Woodland's insolvency and eventually got it all back *from IEI*. BTC received a $130,000 cash down payment on the MIL Stock. It received payments totalling $368,000 on the Acquisition/Renewal Note and the "put"; $320,000 of this amount was cash *not* borrowed from BTC. BTC received dividends of $1,000 on the IEI Stock. After IEI's bankruptcy BTC collected $12,000 on the "put" (liquidation of collateral), another $117,000 from the bankruptcy trustee and another $400,000 from the guarantors of the Acquisition/Renewal Note. By accruing interest and service charges on a moneyless "loan", BTC creates a paper loss that hides a remarkable recovery—approximately $980,000 cash on $950,000 of Woodland Operations Loans.

BTC's successes, large or small, are at least partially a result of Thrift Certificates. Many thousands of dollars of Thrift Certificate proceeds were paid by IEI to BTC, and IEI could not have lived so long and given so much money and collateral to BTC without the Thrift Certificate program.

Despite its vehement denial, BTC was extremely knowledgeable about Thrift Certificates. It knew what they were, how they were sold and whom they benefited. BTC knew about IMF, its assets and its negative net worth. It knew about IEI's worthless "unlimited guarantee" of the Thrift Certificates. It knew that IEI, a company that could not pay its obligations as they matured and whose liabilities exceeded the liquidation value of its assets, was selling unsecured Thrift Certificates at a vigorous rate. It knew that Thrift Certificates were unregistered and unmonitored because of a serious "deficiency" in the Iowa securities laws. The "moral" aspects of Thrift Certificate-

type securities bothered BTC. "[T]he small fellow with a few bucks—a few dollars that wanted to make more than he could at the bank was—you know, he was led into the thing and figured that he made a big deal." BTC thought that Iowans were gullible. "It has always amazed me how in the great state of Iowa people were able to hock stock . . . without any real information being passed off to prospective purchasers, so [large Thrift Certificate sales] did not surprise me."

I. Summary of BTC's Power to Control

BTC's power to control IEI is primarily a function of its ownership/possession of the IEI Stock, the MIL Stock and the MIL Proxy and the purposes, uses and implications thereof. BTC's unusual relationship to IEI is also indicative of control. In the opinion of BTC's senior loan officer, a debtor's primary lender "can exert any kind of pressure" it wants. BTC was IEI's "largest lender" and "principal lender", and IEI knew that BTC could have "pulled the plug any time". BTC's president had a good relationship with IEI management. He "had access to the officers"; if he "needed anything from [IEI] . . . [he] could have accomplished it". IEI's management knew what BTC's "wishes were on anything in relation to [IEI and MIL]" and "knew what BTC expected". BTC management was in almost daily contact with BTC, and BTC "never had any surprises".

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REASONS FOR DENYING THE WRIT

THIS COURT SHOULD NOT GRANT CERTIORARI WHEN THE DECISION OF THE COURT OF APPEALS IS NOT IN CONFLICT WITH DECISIONS OF OTHER COURTS OF APPEALS OR WITH PRIOR DECISIONS OF THIS COURT, IS INTERLOCUTORY AND AFFECTS ONLY THE PARTIES TO THIS ACTION, AND IS BASED UPON A FACT QUESTION IN THE CONTEXT OF APPROPRIATE SUMMARY JUDGMENT STANDARDS CORRECTLY APPLIED.

In seeking to persuade the Court to exercise its extraordinary and discretionary certiorari jurisdiction, BTC seizes upon isolated statements in the opinion of the Court of Appeals and contends that court's decision "effectually" contravenes this Court's prior decision in *Ernst & Ernst v. Hochfelder,* 425 U.S. 185 (1976), and conflicts with the decisions of the Third and Fifth Circuits in *Monsen v. Consolidated Dressed Beef Co.,* 579 F.2d 793 (3d Cir.), *cert. denied,* 439 U.S. 930 (1978), and *Woodward v. Metro Bank of Dallas,* 522 F.2d 84 (5th Cir. 1975). These contentions are neither meritorious nor sufficiently significant to warrant the grant of certiorari.

The biggest hurdle confronting BTC is the absence of any real dispute concerning the applicable legal standards. The standards utilized by the Eighth Circuit in this case are consistent with the scienter requirement delineated in *Hochfelder* and the aiding and abetting principles expressed in *Monsen* and *Woodward.* Indeed, the Court of Appeals expressly agreed with BTC concerning the proper legal standards to be applied. However, based upon its careful review of the voluminous record, it concluded that a jury issue did exist concerning aiding and

abetting liability, and for that reason set aside the grant of summary judgment in BTC's favor on that issue. In actuality, BTC's disagreement with the facts and the inferences to be drawn therefrom is the only real issue raised in its petition.

In examining the legal standards governing liability for aiding and abetting violations of the securities laws, the Court of Appeals reiterated the three-pronged test previously adopted by that circuit in *Stokes v. Lokken,* 644 F.2d 779 (8th Cir. 1981), and generally recognized by the federal courts. By its own terms, this standard is completely consistent with the scienter requirement of *Hochfelder.* As the court in *Stokes* observed in adopting this test, *Hochfelder* "clearly eliminates negligence as a possible basis for a finding of liability . . . ." *Stokes,* 644 F.2d at 783. The Eighth Circuit's thorough discussion of the standard in this case leaves no doubt that aiding and abetting liability cannot be predicated upon negligence. *Metge v. Baehler,* Appendix to Petition for Certiorari at A-3-6, 762 F.2d 621, 624-25 and n. 1 (8th Cir. 1985). Indeed, the court specifically held that a "high standard of intent" and "high scienter standard" must be satisfied at trial before liability may be imposed on BTC. *Id.* This standard of liability comports with the scienter requirement of *Hochfelder.*

It is also apparent that the liability standard utilized by the Eighth Circuit is consistent with that employed by the Third and Fifth Circuits in *Monsen* and *Woodward, supra.* In fact, the Court of Appeals expressly adopted the formulations of aiding and abetting liability set forth in those decisions. *Metge,* Appendix to Petition for Certiorari at A-4-6, 762 F.2d at 624-25. Nothwithstanding

BTC's protestations to the contrary, the legal standards applied by the Court of Appeals do not deviate in any way from *Hochfelder, Monsen* or *Woodward.* Therefore, the petition does not present a sufficiently significant question to warrant the exercise of this Court's extraordinary and discretionary certiorari jurisdiction.

The only real question raised in BTC's petition concerns the application of undisputed legal standards to the particular facts of this case and is of interest only to the parties actually involved. BTC's petition constitutes nothing more than a dispute between it and the Court of Appeals as to what the facts are or may be found to be and an attempt to draw the Court into a reevaluation of those facts and the inferences to be drawn therefrom. Fact canvassing of this nature is not the purpose of a grant of certiorari.

> Certiorari is granted only "in cases involving principles the settlement of which is of importance to the public as distinguished from that of the parties, and in cases where there is a real and embarrassing conflict of opinion and authority between the circuit courts of appeal."

N.L.R.B. v. Pittsburgh Steamship Co., 340 U.S. 498, 502 (1951) (*quoting Layne & Bowler Corp. v. Western Well Works,* 261 U.S. 387, 393 (1923)). "Granting of the writ would not be warranted merely to review the evidence or inferences drawn from it." *General Talking Pictures Corp. v. Western Electric Co.,* 304 U.S. 175, 178 (1938).

The inappropriateness of a grant of certiorari in these circumstances is heightened because the evidentiary review requested by BTC would perforce require this Court to enter into a factual quagmire. This case is based upon complicated and voluminous facts. The record

includes over 13,900 documents and over 9,000 pages of deposition testimony. The appendix filed in the Court of Appeals was 2405 pages. The time consuming evidentiary review which would be required of the Court cannot be justified where no conflicting legal principles are involved. Further review by the Court is unwarranted.

Additional factors also militate against the grant of certiorari in this case. The Eighth Circuit's decision only reversed the district court's grant of summary judgment in BTC's favor on the aiding and abetting claim. No actual findings of fact have been made in this case, and there has been no imposition of liability. Rather, the Court of Appeals, after a careful review of the record as a whole, has merely concluded that a jury question is presented. Where the sole result of the Eighth Circuit's decision is a remand for trial on the merits pursuant to generally accepted standards of liability, the decision is properly significant only to the parties involved. In these circumstances, plenary consideration by this Court is premature and unnecessary.

The Court of Appeals also applied the appropriate standard in reviewing and reversing the grant of summary judgment. As evidenced by its detailed opinion, the court carefully evaluated the complex and voluminous record and found there to be sufficient evidence to present a jury question concerning BTC's liability for aiding and abetting the primary securities violations. The record firmly supports this conclusion. It shows, and a jury can properly find, the following: BTC embarked on an unusual and continuing course of conduct to recover large and unusual loan losses from a borrower; by this course of conduct BTC substantially assisted the borrower's primary violations of the anti-fraud provisions of the

federal securities laws; BTC was aware of the primary violations and its assistance thereto and role therein; BTC consciously intended to assist in the primary violations or had a conscious and specific motivation for not acting to stop or disclose the primary violations; and BTC knowingly benefited from the primary violations.

The main thrust of the petition is a claim that there is no evidence that BTC knew the primary violations were being committed. As is true in many securities fraud cases, particularly those involving secondary liability, Plaintiffs must prove critical state-of-mind facts, such as knowledge, intent and motive, by inferences and circumstantial evidence. *E.g., Woodward,* 522 F.2d at 96. The evidence outlined in the Statement of Facts section of this brief and by the Court of Appeals provides a basis from which a jury could properly infer and conclude that BTC knew of the primary violations and knowingly and substantially assisted therein.

Finally, the decision of the Court of Appeals will in no way chill or proscribe normal and legitimate banking activities. In this case BTC went far beyond routine and acceptable loan collection practices. It involved itself intimately in the affairs of its borrower, assisted in a fraud on the borrower's other, less sophisticated creditors through a series of unusual, manipulative and disguised transactions and knowingly benefited therefrom. BTC's actions place it beyond the boundaries of normal and legitimate banking activities. The Court of Appeals recognized this in its tightly-worded opinion. Lending institutions engaged in ordinary and legitimate banking activities need not be alarmed.

CONCLUSION

The petition presents no substantial issues for review by this Court. The legal standards utilized by the Court of Appeals in reversing the grant of summary judgment are consistent with the prior decisions of this Court and are generally accepted by the lower federal courts. In actuality, the only real issues raised by the petition center on the particular facts of this case and are of concern only to the parties involved. The inappropriateness of a grant of certiorari in such circumstances is well-recognized. A grant of the writ in this case would be particularly inappropriate given the voluminous and complex factual record involved. The fact that this matter arises in the context of summary judgment and that trial on the merits is yet to occur further marshalls against review by this Court at this time. In these circumstances, the Petition for a Writ of Certiorari should be denied.

Respectfully submitted,

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DATE: October 28, 1985

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No. 85-555

IN THE

Supreme Court of the United States

OCTOBER TERM, 1985

BANKERS TRUST COMPANY,
Petitioner,

vs.

THELMA T. METGE, Executrix of the Estate of August Metge, and ELIZABETH G. SHEPARD, on behalf of themselves and on behalf of all others similarly situated,
Respondents.

On Writ of Certiorari to the United States Court of Appeals For the Eighth Circuit

REPLY BRIEF OF PETITIONER TO RESPONDENTS' BRIEF IN OPPOSITION

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REPLY BRIEF OF PETITIONER TO RESPONDENTS' BRIEF IN OPPOSITION

Respondents are in error in asserting that the Bank's Petition for Certiorari merely raises factual arguments. As Judge Stuart found, the facts are not in dispute, only the inferences which may be drawn from the facts.

Accepting the facts recited by the Court of Appeals for the Eighth Circuit at face value, they do not show substantial evidence of aiding-abetting. The Court of Appeals only recites facts showing "knowledge of the program" (that Thrift Certificates were being sold). It does not indicate any facts showing knowledge of the violation, actual knowledge that the fraud of non-disclosure was occurring.

Similarly, on the element of substantial assistance to the violation, the Eighth Circuit cites no facts showing substantial assistance by the Bank to the violation or fraud. There is a clear difference between the opinions of the District Court and Circuit Courts here. Judge Stuart correctly found that the substantial assistance must be to the violation, to the fraud itself, not merely to the violator generally. The Eighth Circuit does not recognize this difference and holds that assistance to the violator in "keeping it afloat", that is not calling the loan, constitutes assistance to the fraud. No other Court has so held.

Decisions are not made in a vacuum. A Court of Appeals cannot recite a correct rule of law and then mis-apply the undisputed facts to the law to secure an incorrect result. A simple reading of the opinions of the District Court and Court of Appeals shows an inherent difference in the application of the same facts to be the same law. This difference is so glaring that this Court could well exercise its general supervisory powers over the Courts of Appeal by ordering summary reversal and reinstatement of the District Court's opinion.

Respectfully submitted,

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On Petition for a Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

MOTION OF THE AMERICAN BANKERS ASSOCIATION FOR LEAVE TO FILE BRIEF AS AMICUS CURIAE AND BRIEF IN SUPPORT OF PETITION

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October 28, 1985

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Respondents.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

MOTION OF THE AMERICAN BANKERS ASSOCIATION FOR LEAVE TO FILE BRIEF AS AMICUS CURIAE IN SUPPORT OF PETITION

To the Honorable, the Chief Justice of the United States and the Associate Justices of the Supreme Court of the United States:

The American Bankers Association respectfully moves, pursuant to Rule 36 of the Rules of this Court, for leave to file the attached brief as *amicus curiae*.

INTEREST OF THE AMERICAN BANKERS ASSOCIATION

The American Bankers Association is the largest national trade organization for the commercial banking industry in the United States. Its membership includes approximately 12,000 banks, or more than 82% of the industry. American Bankers Association member banks are located in each of the fifty states and the District of Co-

lumbia and include banks chartered by the United States and those chartered by their respective states.

This class action case involves reversal by the Eighth Circuit of a grant of summary judgment in favor of a commercial bank accused of aiding and abetting an alleged securities fraud by a borrower of the bank. A decision for the respondents here would expand the reach of the securities laws and their armamentarium of remedies by equating a lender's legitimate, business necessity-based knowledge of its borrower's sales activities with the scienter requirement for a finding of aider and abettor liability. Such a holding would so expand the investigatory and disclosure burdens on banks and other sources of commercial credit that their willingness to make such loans could be reduced, resulting in attenuated credit availability and higher rates to cover the higher attendant risks. Placing commercial banks at risk because of a heightened disclosure standard would in turn create liability for them in those states whose constitutions or statutes reinforce the inherent privacy of the relationship between a bank and its private borrowers. Beyond this enhanced lender liability, federalization of disclosure standards as a result of a holding for respondents here would do structural damage to state initiatives to protect and enhance privacy.

Counsel for the petitioner has consented to the filing of this brief under Rule 36, and a copy of that consent is filed herewith. Counsel for respondents has declined to consent.

WHEREFORE, it is respectfully requested that the Court grant leave to the American Bankers Association to file the attached Brief as *Amicus Curiae* in support of the petition for a writ of certiorari.

Respectfully submitted,

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QUESTION PRESENTED FOR REVIEW

Whether the court below correctly interpreted aider and abettor liability provisions of Section 10(b) of the Securities Exchange Act of 1934 to expand a bank's duty of disclosure of material information to its borrower's clients despite bank's positive duty not to disclose details of bank's private relationship with its borrower.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1985

No. 85-555

BANKERS TRUST COMPANY,

Petitioner,

v.

THELMA G. METGE, Executrix of the Estate of AUGUST METGE, and ELIZABETH G. SHEPARD, on behalf of themselves and on behalf of all others similarly situated,

Respondents.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

BRIEF OF THE AMERICAN BANKERS ASSOCIATION AS AMICUS CURIAE IN SUPPORT OF PETITION

INTEREST OF THE AMICUS CURIAE

The American Bankers Association respectfully submits this brief as *amicus curiae* to urge the Court to grant the petition for a writ of certiorari to review a decision of the United States Court of Appeals for the Eighth Circuit. In that decision the court reversed a grant of summary judgment for petitioners (Bankers Trust Company) by the District Court on the issue of aider and abettor liability for a violation of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (1981) and of Securities and Exchange Commission Rule 10b-5, 17 C.F.R. § 240.10b-5 (1984).

As shown in the foregoing motion, a reversal of the summary judgment and any eventual finding of bank aider and abettor liability could have very significant negative impacts on any ABA member bank that makes loans

to an entity that markets its own shares or other investment vehicles. An interpretation extending the grounds for a finding of aider and abettor liability to the case where there is not only no demonstrable duty to the bank's borrower's securities clients but also a positive, state-based duty to preserve privacy could so increase ABA member banks' risks that lending to borrowers who raise capital by securities sales could be curtailed at worst and at least made more expensive. Such an extension of the grounds for liability would fundamentally alter the relation between a bank and its customers by forcing banks actively to police the securities offerings of its borrowers and to serve essentially as guarantors of their veracity, reliability, and profitability. Such a situation would represent a fundamental shift in the dynamics of lending by banks.

SUMMARY OF THE ARGUMENT

A finding of aider and abettor liability for violations of Section 10(b) of the Securities Exchange Act of 1934 may be based on satisfaction of three prerequisites. As developed in the Circuit from which this case comes to bar, there must be "a securities law violation by the primary party (as opposed to the aiding and abetting party); . . . 'knowledge' of the violation on the part of the aider and abettor; and . . . 'substantial assistance' by the aider and abettor in the achievement of the primary violation." *Stokes* v. *Lokken*, 644 F.2d 779, 782-83 (8th Cir. 1981). The second and third prerequisites, scienter and substantial assistance, vary inversely; where one is minimal, a greater showing of the other is required. *Woodward* v. *Metro Bank of Dallas*, 552 F.2d 84, 95 (5th Cir. 1975). The substantial assistance test may be met even by inaction if the inaction occurs in the face of a duty to act, *IIT, An International Investment Trust* v.

Cornfeld, 619 F.2d 909, 927 (2d Cir. 1980), especially if the claimed duty takes the form of some "special duty of disclosure." *Woodward*, 522 F.2d at 97.

These rules address two classes of cases, those where there is a duty to disclose material facts and those where the duty is absent. There is, however, a third, as yet unaddressed, category of cases that arises when a bank has a positive duty not to disclose the details of, and the information generated by, its relationships with its customers. The banking industry has a distinct interest in influencing the development of rules governing this third class of cases. Absent such rules, banks may find themselves subjected to irreconcilable obligations that on the one hand require them to make disclosures in order to avoid liability under Section 10(b) and on the other to observe a positive, state-based, unpreempted duty to preserve customer confidentiality. In such circumstances, banks would suffer liability no matter which of the two conflicting standards they ultimately choose to obey; they would certainly be without the ability to observe both.

Though the Court has clearly settled the rule that scienter is a requirement of a showing of securities fraud under Section 10(b) and Rule 10b-5, *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 (1976), it has so far declined directly to address the correctness of the three-prong test for aider and abettor liability. This court specifically declined to do so in *Ernst & Ernst*, 425 U.S. at 191, n. 7.

For these reasons, we contend that the case at bar presents an important question of Federal law which has not been, but should be, settled by this Court under its Rule 17(c). We do not at this point suggest the outlines of what those rules might be. Should this Court grant a writ of certiorari, we would, with the Court's indulgence, address proposed rules for the third class of cases in a brief as *amicus curiae*. For the present, our discussion is

restricted to the limits of previous case law and Federal statutes and to the existence of state law-based duties for banks not to disclose the financial affairs of their customers.

ARGUMENT

Where A Bank Has A Positive Duty Not To Disclose Its Customer's Affairs, The Relationship Between The Second And Third Prongs Of The Aider-Abettor Liability Test Requires An Extraordinary Showing of Knowledge Of The Primary Securities Violation And Raises An Important Question Which Has Not Been, But Should Be, Settled By This Court.

A. *Basis of Aider and Abettor Liability*

The claim that a party is liable as an aider and abettor of securities fraud under Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (1981) and of Securities and Exchange Commission Rule 10b-5, 17 C.F.R. § 240.10b-5 (1984) rests on a three-pronged test, each part of which must be satisfied for liability to result. As developed by the process of judicial interpretation, the test requires that there be "a securities law violation by the primary party (as opposed to the aiding and abetting party); . . . 'knowledge' of the violation on the part of the aider and abettor; and . . . 'substantial assistance' by the aider and abettor in the achievement of the primary violation." *Stokes, supra,* p. 2.

The second and third prongs of the test, those setting out requirements for scienter or knowledge of the primary violation and for substantial assistance in commission of the violation, share an inverse relationship; where the degree shown of one is minimal, a greater showing of the other must be made. *Woodward, supra,* p.

3. The substantial assistance test may be met by a showing of positive action or of inaction if the inaction took place in the face of a duty to act. *IIT, supra* pp. 2-3. Inaction readily satisfies the substantial assistance test if the putative duty takes the form of some "special duty of disclosure" to one harmed in a securities transaction. *Woodward, supra* p. 3, at 97.

A showing of minimal knowledge may suffice if accompanied by a strong showing of substantial assistance. But if the equivalent of a negative degree of assistance could be shown by proof of a positive duty not to act, then a showing of an extraordinary degree of knowledge of the primary violation, one far beyond even that suggested by proof offered to support respondents' failed "controlling person" count (*Metge* v. *Baehler*, 762 F.2d 621, 630-632, (8th Cir. 1985)), should be required. It is even possible that a showing of a positive duty not to disclose may not logically be overcome by even a strong showing of scienter and may raise a presumption that scienter is absent.

B. *Limits of Rules Denying Bank Customer Privacy*

It is well settled that an accused in a Federal prosecution has no Fourth Amendment right to protection of his papers and effects against unreasonable searches and seizures that can be vindicated by resistance to a subpoena *duces tecum* seeking production of the checks, deposit slips, and other records relating to his bank accounts. *U.S.* v. *Miller*, 425 U.S. 435 (1976). An accused in a Federal prosecution likewise has no Fourth Amendment-based expectation of privacy related to such materials when sought by appropriate process. *Id.*

Nor is there relief for such an accused in Federal statute. The Right to Financial Privacy Act of 1978, 12 U.S.C. §§3401 – 3422 (1980), was clearly a response to

the perceived sweep of *Miller*. Financial Institutions Regulatory and Interest Rate Control Act of 1978, H. Rep. No. 1383, 95th Cong., 2d Sess. 34, *reprinted* in 1978 U.S. CODE CONG. & AD. NEWS 9273, 9306. The Act bars Federal government access to the financial records of any customer of a financial institution unless the records are reasonably described and the customer authorizes the disclosure or the records are disclosed pursuant to an administrative subpoena or summons, a search warrant, a judicial subpoena or a formal written request of a Federal government authority. 12 U.S.C. § 3402. Thus, while on the one hand creating strict limits to government access to a bank customer's records and a method for resisting access, the Act also condones and regulates the process by which a customer's records may be accessed.

Federal preemption of state law also affects any assessment of bank customer record privacy. Preemption generally arises if "Federal legislation has left the State with no duties or responsibilities" in a field and occupied the entire field of concern. *Warren Trading Post Co.* v. *Arizona Tax Comm'n*, 380 U.S. 685, 691 (1965). Preemption also occurs where there is a clear collision between state and Federal law. *Hamm* v. *Rock Hill*, 379 U.S. 306, 311 (1964). Any state legislation that frustrates the full effectiveness of Federal law is rendered invalid by the Supremacy Clause. *Perez* v. *Campbell*, 402 U.S. 637, 652 (1971). But a state law is not preempted merely because it has a purpose identical with that of a Federal law; to be invalid, the state law would have to frustrate the purpose of the Federal statute to some extent. *Colorado Anti-Discrimination Comm'n* v. *Continental Air Lines*, 372 U.S. 714, 722 (1963).

Given the clear limit of the coverage of the Right to Financial Privacy Act to customer record access by the Federal government, it may not fairly be said that preem-

ption occurs as a result of a Congressional intent to occupy the whole field of access to bank customer records. 12 U.S.C. §§ 3401-3403. An example of a conflict between operation of the Act and a state provision occurred where a grand jury investigation was impeded by a claim of applicability of a Connecticut statute governing service of process and providing for notice to the customer and an opportunity to challenge access (Conn. Gen. Stat. §§ 36-9j – 36-9o (1981)). The court held the Federal statute controlling and upheld the grand jury's subpoena. *In re Grand Jury Subpoena (Conn. Sav. Bank)*, 481 F.Supp. 833, 834 (D. Conn. 1979).

An additional issue is whether Federal law preempts or supplants state law on point. Federal securities statutes explicitly recognize concurrent jurisdiction of the states in regulating securities. *North Star Intern.* v. *Arizona Corp. Comm'n*, 720 F.2d 578, 582 (9th Cir. 1983), *citing* 15 U.S.C. 77r (1981) (upholding merit review of securities sale when no conflict with Federal law is found). Similarly, a Federal court has upheld state securities registration provisions in the face of preemption claims where there is no conflict and by virtue of Federal statutory recognition of the right of states to legislate in the securities field. *Underhill Associates, Inc.*, v. *Bradshaw*, 674 F.2d 293, 195-96 (4th Cir. 1982), *citing* 15 U.S.C. 78a *et seq.* Federal courts are clearly practicing a jurisprudence that allows for operation of nonconflicting state securities statutes. Given this room for state law to operate in the field of securities regulation, situations such as the one at bar leave banks potentially caught between the rock of a Federal claim against them based on nondisclosure and the hard place of state law requiring protection of bank customer record confidentiality.

The string that runs through *Miller*, the Act, and its preemptive capacity is that they reach only a portion of

the issues surrounding the confidentiality of bank records. How broad is *Miller's* reach? It affects the records of every accused Federal defendant but goes no further. How far does the Right to Financial Privacy Act go? It goes only far enough to regulate Federal access to records and resistance to that access. How many bank-related confidentiality concerns are preempted by Federal law? Only those attempting to occupy or affect the narrow field of regulation of Federal investigatory activities or those interpreted to conflict with Federal investigations are preempted. Thus, the string running through these Federal resolutions of bank privacy issues is also a strong rope binding them tightly within only a portion of the broader category of bank privacy and confidentiality concerns.

If the requested access is not from a Federal entity, federal law does not control. If the issue is not duplicative of Federal law or an impediment to a Federal investigation, Federal law does not control. And if a right to privacy is asserted independently of the reach of Federal action or of state application of the Fourth Amendment through the Fourteenth Amendment, Federal law does not control.

C. *Duty Not To Disclose*

What, then, is left? Once the limits of Federal law on bank record confidentiality are reached, how much, if any, of the field is left unaffected and unpreempted? The answer is illustrated by the case at bar and by substantive rights to privacy rooted in state constitutions and statutes.

The constitutions of several states go beyond the Federal Constitution and explicitly create a right to personal privacy. These privacy rights are separate and distinct

from state-based rights comparable to those protected by the Fourth Amendment. The Alaska Constitution declares, "The right of the people to privacy is recognized and shall not be infringed." Alaska Const. art. I, § 22. Arizona and Washington provide that "No person shall be disturbed in his private affairs, or his home invaded, without authority of law." Ariz. Const. art. 2, § 8; Wash. Const. art. I, § 7. California includes "pursuing safety, happiness, and privacy" among the inalienable rights of her people (Cal. Const. art. I, § 1), and Hawaii declares that "The right of the people to privacy is recognized and shall not be infringed without the showing of a compelling state interest." Hawaii Const. art. I, § 6. Illinois, Louisiana, and South Carolina assign protection against "invasions of privacy" equal status with protection against unreasonable searches and seizures. Ill. Const. art. 1, § 6; La. Const. art. 1, §5; S.C. Const. art. I, §10.

These constitutional protections exist separately from, or coequally with, the class of rights protected by the Fourth Amendment and its state analogues. As such, they demonstrate the existence of bases for finding free-standing, unpreempted rights to bank confidentiality unaffected by the prior decisions of this Court or by any decision based on a reading of the observably limited reach of the Fourth Amendment. When combined with the restrictions imposed by the state action requirement of the Fourteenth Amendment, private transactions that include inquiries about the details of a bank's relations with its customers stand apart from those official—Federal, state, or local investigative—inquiries permitted to lift the mantle of confidentiality that inheres in the relationship.

A number of states have statutes in place that perform much the same function as the Federal Right to Financial Privacy Act; that is, they regulate the means by which

access is permitted by official inquirers. *E.g.*, Alaska Stat. § 06.05.175 (1984); Okla. Stat. Ann. tit. 6, §§ 2201 – 2205 (West 1984); Utah Code Ann. §§ 78-27-45 – 78-27-50 (1977). Other state statutes regulate similar official access and also permit some narrowly defined categories of private access. These include access for the purpose of performing independent audits by a certified public accountant or as a part of an exchange of credit information (*e.g.*, Ill. Ann. Stat. ch. 17, ¶ 360 (Smith-Hurd Supp. 1985), Md. Fin. Inst. Code Ann. §§ 1-301 – 1-305 (Supp. 1985)), exchanges of information relating to dishonor of a negotiable instrument (*e.g.*, Conn. Gen. Stat. §§ 36-9j – 36-9o (1981)), and other particularly described exemptions (*e.g.*, exchanges of mortgage account information in the regular course of business, Md. Fin. Inst. Code Ann. § 1-303 (Supp. 1985)).

What the state statutes, many of them passed in the same year or soon after *Miller* (*e.g.*, Cal. Gov't Code §§ 7460 – 7480 (Deering 1982); Conn. Gen. Stat. §§ 36-9j – 36-9o (1981); La. Rev. Stat. Ann. § 9:3571 (West 1983); Neb. Rev. Stat. §§ 8-1401, 8-1402 (1983); N.H. Rev. Stat. Ann. §§ 359-C:1 – 359-C:6 (1984)), have in common is a determination to permit specified classes of official and, in some cases, private inquirers to access bank customer financial records only under controlled circumstances. By clearly outlining these circumstances, the statutes unmistakably divide specifically permitted access from the general rule of confidentiality. They also divide the use of information that may be taken from bank records from the general rule of nonuse of this information. These emphatic divisions serve to delineate, in the clearest possible manner, the limits of the reach of *Miller* and of permitted Federal and State inquiries under color of the Fourth Amendment. By drawing these limits, they also serve to point up the existence of wholly unaffected

rights to confidentiality in the relations between banks and their customers.

The significance of this undiluted preserve of customer confidentiality is that its existence places banks under clear duties not to disclose information about their customers' finances without specific authority to do so. It would thus be impossible for a bank to bandy about the details of its loans to a customer involved in sales of securities without risking liability under these constitutions and statutes. Yet application of Section 10(b) and Rule 10b-5 as suggested in the case at bar would impose liability on banks even as they attempted to avoid liability under color of state law.

The situation is as we have earlier described it: There are rules for the case where there is a duty to disclose and rules for the case where there is no duty. What prevents existence of a complete, principled jurisprudence on point is the lack of rules governing the third case, the case where a bank confronts a positive, free-standing, unpreempted duty not to disclose its customer's finances. Once these rules are elucidated, their effect on the showing required of a plaintiff can be determined. If there is a showing of a positive duty not to disclose, is there any degree of scienter that could be shown that would overcome that duty? Or would a showing of such a duty constitute a new presumption that could only be overborne by additional evidence?

These points raise an important issue of Federal securities law as yet undecided by this Court. They reveal a conflict among the reach of settled Federal case law and a variety of state constitutional and statutory requirements. And they indicate an area of Federal law not yet definitively addressed.

CONCLUSION

For all of the reasons stated herein, the *amicus* American Bankers Association, on behalf of its approximately 12,000 member banks, respectfully urges this Court to grant the petition for a writ of certiorari.

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